Pacific Safety Products Inc.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (UNAUDITED)

## FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2008

PSP™

Pacific Safety Products Inc.

# Investor Report

## Fiscal 2009, Quarter Two

**Interim Results for the quarter ended December 31, 2008 with Comparative Results for 2007**

## MANAGEMENT DISCUSSION AND ANALYSIS

**Mission**

*...we bring everyday heroes home safely.™*

The following discussion is intended to assist readers in better understanding and evaluating Pacific Safety Products ("PSP" or the "Company") history, business environment, strategies, performance and risk factors as well as the financial condition and operations for the three month period ended December 31, 2008. It is recommended that the information provided in this report be read in conjunction with PSP's consolidated financial statements and notes for the twelve month period ended June 30, 2008, message to shareholders and other management discussions included in the Company's annual report. The information in this report includes information available to February 6, 2009, and includes forward-looking statements based on current expectations and is subject to risks and uncertainties. Many internal and external factors may cause actual results to differ materially. Unless otherwise indicated all dollar amounts shown are expressed in Canadian dollars.

Management is responsible for the preparation and integrity of the consolidated financial statements, including maintenance of appropriate information systems, procedures and internal controls, and to ensure that information used internally or disclosed externally, including the consolidated financial statements and management's discussion and analysis, is complete and reliable.

**OVERVIEW OF THE BUSINESS**

PSP is an established industry leader in the defence and security market. The Company is engaged in the design, production, sale and distribution of protective and duty products for Law Enforcement, Security and Defence. PSP's products are worn or included in equipment used by officers, agents, guards and military personnel. The Company has a significant market position in Canada, particularly in soft body armour where it's the largest manufacturer. The Company also provides specialized law enforcement and safety products through APS Distributors Ltd. ("APS"), a division of PSP that services law enforcement and public safety agencies across Canada. The Company, through its wholly owned subsidiary Sentry Armor Systems Inc. ("Sentry"), provides body armour products to U.S. based law enforcement and private security firms. The Company's business strategy is to maintain its core markets while growing its portfolio of products so that more of what a customer wears or carries to the front line is sold by PSP.

PSP has a significant recurring revenue stream from its Canadian customers in the form of standing contracts with terms of up to five years. These contracts are with Federal, Provincial and Municipal organizations and agencies. The Company also pursues long-term defence contracts. PSP has been successful in supplying the Canadian Military with Fragmentation Protection products and Chemical and Biological Protection suits. The Company's U.S. business is primarily supplying State, County and Municipal Law Enforcement agencies with soft body armour. These products are often sold through a national distribution network.

PSP has a Research and Development program that works cooperatively with customers on new product design as well as independent research in future technologies and products that will enhance user effectiveness, increase value and survivability.

PSP has manufacturing operations in Arnprior, Ontario and Dover, Tennessee, a distribution centre in Halifax, Nova Scotia and its head office is located in Ottawa, Ontario. Its design and production facilities are all ISO9001 compliant. Founded in 1984, PSP has grown to currently include more than 240 employees at its Canadian and U.S. facilities.

The financial data has been prepared in accordance with Canadian Generally Accepted Accounting Principles and the Company's reporting currency is the Canadian dollar. Pacific Safety Products Inc. is a reporting issuer in Canada in the provinces of British Columbia, Alberta and Ontario. The Company trades on the TSX Venture Exchange under the symbol PSP. Additional regulatory information relating to Pacific Safety Products Inc. can be found at the System for Electronic Document Analysis and Retrieval ("SEDAR") web site at www.sedar.com.

**Market Conditions**

The market for Law Enforcement and Security products in Canada remains strong despite the current economic climate. Normal buying patterns by major customers follows a seasonal cycle with the third and fourth quarter typically being the strongest in terms of revenue. This market accounts for approximately two thirds of the Company's business volume.

The defence markets in both Canada and the U.S. typically consist of large volume multi-year production runs followed by routine replenishment cycles as in-service products are replaced. PSP's defence products in Canada currently accounts for approximately 10% to 15% of annual revenue. PSP also pursues funded R&D opportunities in this market. PSP has also entered the US defence market with an enhanced helmet liner product. The Company anticipates growth in the defence market over the next five years assuming that it is able to finance the required product development.

The Company's U.S. market for soft body armour to Law Enforcement Agencies is potentially impacted by the economic recession, however sales to international customers continues to offset this trend and overall this market continues to be a growth area for the Company. Currently the U.S. market accounts for approximately 20% of total revenue, up from 13% in FY08 and 2% in FY07.

## HIGHLIGHTS OF THE QUARTER

- Sales increased by 32% or $2.3 million to $9.6 million as compared to the same period of the prior year.
- Gross margin improved by almost 7 percentage points to 25% as compared to the same period of the prior year.
- The Company announced a multi-year contract, with a potential value of up to $14.0 million with the Canada Border Services Agency.
- US body armour sales more than doubled during the quarter as compared to the same period of the prior year.
- The Company's next generation military helmet liner was tested and recommended by the members of the US National Tactical Officers Association as disclosed in the Company's media release of November 24, 2008.
- Operating expenses decreased 6% during the quarter as compared to the same period of the prior year.

## CONSOLIDATED RESULTS OF OPERATIONS

| *SUMMARY OF OPERATIONS* | ***THREE MONTHS ENDED DECEMBER 31, 2008*** | *THREE MONTHS ENDED DECEMBER 31, 2007* | ***SIX MONTHS ENDED DECEMBER 31, 2008*** | *SIX MONTHS ENDED DECEMBER 31, 2007* |
|---|---|---|---|---|
| SALES | $ 9,592,792 | $ 7,282,922 | $ 17,299,158 | $ 13,948,082 |
| COST OF SALES | 7,182,685 | 5,954,997 | 13,016,029 | 11,113,827 |
| GROSS MARGIN | 2,410,107 | 1,327,925 | 4,283,129 | 2,834,255 |
| EXPENSES | 2,363,995 | 2,466,564 | 4,422,831 | 4,189,850 |
| INCOME (LOSS) BEFORE OTHER ITEMS AND TAXES | 46,112 | (1,138,639) | (139,702) | (1,355,595) |
| OTHER ITEMS | 152,150 | 744,673 | 152,150 | 505,302 |
| INCOME (LOSS) BEFORE INCOME TAXES | (106,038) | (1,883,312) | (291,852) | (1,860,897) |
| INCOME TAX EXPENSE (RECOVERY) | (147,796) | (518,829) | (341,367) | (615,370) |
| INCOME (LOSS) | $ 41,758 | $ (1,364,483) | $ 49,515 | $ (1,245,527) |
| BASIC AND FULLY DILUTED INCOME (LOSS) PER SHARE | $ 0.002 | $ (0.054) | $ 0.002 | $ (0.050) |
| WEIGHTED AVERAGE BASIC COMMON SHARES ISSUED AND OUTSTANDING | 25,467,694 | 25,091,728 | 25,467,694 | 24,677,351 |

## RESULTS OF OPERATIONS

### Sales

Sales for the three month period ending December 31, 2008 were $9.6 million, an increase of $2.3 million or 32% as compared to the same period of the prior year. The increase is primarily attributed to increased law enforcement sales in Canada and the United States. These amounts were partially offset by reduced sales from Canadian government contracts. Sales generated from Canadian operations were $6.3 million, an increase of $0.6 million or 10% over the same period of the prior year. This increase is attributed to the Company's strategic investments in the Canadian market, including the acquisition of APS, in order to mitigate the volatility associated with government procurement cycles and its effect on sales. Sales generated from US operations were $3.3 million, an increase of $1.7 million or 112% as compared to the same period of the prior year. This increase is attributed to the Company's strategic investments in the US market including the launch of the GH brand of protective products for the U..S Law Enforcement market and the expansion of distribution channels.

### Gross Margin

For the three month period ending December 31, 2008, gross margin as a percentage of sales increased by 6.9 percentage points to 25.1% as compared to 18.2% in the same quarter of the prior year. The increase is attributed to improved gross margins from U.S. operations primarily due to improved manufacturing efficiency, reduced warranty costs and better overhead absorption related to increased sales volume. Gross margin from Canadian operations also increased as compared to the same period of the prior year, primarily due to improved manufacturing efficiencies as a result of consolidating manufacturing operations at one location and a shift in product mix to higher margin products.

**Expenses**
For the three month period ending December 31, 2008, expenses were $2.4 million, a decrease of $0.1 million or 4.3% as compared to the same period of the prior year. The decrease is primarily due to savings related to the Company's integration and restructuring activities during the quarter, partially offset by approximately $0.1M of costs incurred as a result of the Shareholder dispute leading up to the Company's annual general meeting in December 2008. The Company expects a reduction in expenses of up to $0.8 million annually as a result of the current quarter's integration and restructuring activity.

Research and development (R&D) expenditures for the three month period ending December 31, 2008 were $0.1 million compared to $0.01 million during the same period of the prior year. Expenses included in this category include the costs related to ballistic research materials, testing, product designs, patterns, labour and overhead. The increase in these expenses is in line with management's expectations as the Company continues to invest in new geographies and product lines. During the quarter, management deferred $0.2 million ( Q2 2008 - $0.001 million) in R&D costs relating to new product development projects that have known markets and are expected to come into commercial production at a future date. The increase in deferred R&D is primarily related to the certification of certain product lines as required by the U.S. department of justice.

Amortization of property, plant and equipment was $0.04 million for the three month period ending December 31, 2008 compared to $0.05 million in the same period of the prior year. Amortization of other assets was $0.1 million compared to $0.2 million in the same period of the prior year. The decrease in amortization of other assets is attributed to reduced amortization of intangible assets acquired in the GH and APS acquisitions.

Interest on the operating line for the three month period ending December 31, 2008 was $0.04 million compared to $0.04 million in the same period of the prior year. Interest on long term debt for the three month period ending December 31, 2008 was $0.01 million compared to $0.02 million in the same period of the prior year.

**Other Items**
During the second quarter the Company announced a reduction in its non production staff. This action was taken as a result of realizing efficiency gains in its business systems implementation and a re-balancing of support to simplify its structure and realize synergies related to the acquisition of APS in the second quarter of the prior year.

**Income Taxes**
Income taxes were calculated at an effective rate of 33.5% for Canadian operations and 40.5% for U.S. operations for the three month period ending December 31, 2008. Income tax expense for the current quarter varies from the amount that would be computed by applying the combined federal and provincial tax rate as a result of the tax effect of items not deductible for tax purposes.

**Net Income**
The Company reported net income of $0.01 million for the three month period ending December 31, 2008 as compared to a net loss of $1.4 million in the same period of the prior year. The change in net income as compared to the prior year is primarily due to increased sales, improved gross margins and the recognition of $1.0 million relocation provision in the prior year. Basic and diluted income per share was $0.02 for the quarter compared to a basic and diluted net loss per share of $0.05 in the same period of the prior year.

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)**
EBITDA for the quarter ended December 31, 2008 was $0.2 million compared to a loss of $1.5 million in the same period of the prior year. The calculation of EBITDA includes a one-time restructuring provision of $0.2 million in the current quarter and a one-time relocation provision of $1.0 million and a gain on the disposition of the Kelowna, British Columbia facility in the prior year. The increase in EBITDA in the current quarter as compared to the same period of the prior year is primarily due to increased sales and gross margins and the recognition of the one-time relocation provision in the prior year.

The following is a reconciliation of net income to EBITDA:

| For the three months ended | **December 31, 2008** | December 31, 2007 |
|---|---|---|
| Net income (loss) | **41,758** | (1,364,483) |
| Interest expense | **45,155** | 53,158 |
| Income tax recovery | **(147,796)** | (518,829) |
| Stock based compensation | **47,166** | 45,428 |
| Amortization | **250,950** | 325,625 |
| EBITDA | **237,233** | (1,459,101) |

## CONSOLIDATED QUARTERLY RESULTS

| | **Q2 2009** | Q1 2009 | Q4 2008 | Q3 2008 | Q2 2008 | Q1 2008 | Q4 2007 | Q3 2007 |
|---|---|---|---|---|---|---|---|---|
| Sales | **$9,592,792** | $7,706,366 | $10,210,482 | $10,639,392 | $7,282,922 | $6,665,160 | $11,547,177 | $10,585,366 |
| Net income (loss) | **$41,758** | $7,757 | $724,690 | $299,946 | ($1,364,483) | $118,956 | $283,037 | $355,325 |
| Basic and fully diluted earnings per share | **$-** | $- | $0.02 | $0.01 | ($0.05) | $0.01 | $0.01 | $0.02 |

In Q1 and Q2 of fiscal 2008 the Company recorded lower sales than in previous quarters due to delays in contract awards and an overall reduction in domestic sales due to fluctuations in government procurement patterns. The Company also recorded a one-time provision of approximately $1.0 million in Q2 of fiscal 2008 related to the relocation of the Company from Kelowna, British Columbia to the Ottawa area of Ontario.

### Cash Flow

Cash flow used in operating activities for the three month period ended December 31, 2008 was $0.6 million compared to $2.9 million of cash used in operating activities in the same period of the prior year. The increase in cash flow from operating activities was primarily attributed to increased cash receipts related to increased sales.

The Company used $0.4 million of cash in investing activities for the three month period ending December 31, 2008, primarily related to new product development and investments in property plant and equipment, compared to $4.1 million of cash used in investing activities in the same period of the prior year. Approximately $3.9 million of the cash used in investing activities in the prior year was related to the acquisition of APS.

For the three month period ending December 31, 2008, financing activities generated no cash. The Company generated $1.0 million of cash in the same period of the prior year from the issuance of long-term debt related to the acquisition of APS.

| *CASH FLOW* | ***THREE MONTHS ENDED DECEMBER 31, 2008*** | *THREE MONTHS ENDED DECEMBER 31, 2007* | ***SIX MONTHS ENDED DECEMBER 31, 2008*** | *SIX MONTHS ENDED DECEMBER 31, 2007* |
|---|---|---|---|---|
| Cash flow from (used for) continuing operations | **$(661,119)** | $(2,909,618) | **$(1,227,832)** | $(1,378,376) |
| Investing activities and capital expenditures | **$(397,921)** | $(4,090,293) | **$(614,764)** | $(1,548,913) |
| Financing activities | **$(2,056)** | $1,038,140 | **$97,944** | $(1,003,490) |
| | **$(1,061,096)** | $(5,961,771) | **$(1,744,652)** | $(3,930,779) |

## LIQUIDITY AND CAPITAL RESOURCES

***FINANCIAL POSITION***

| *AS AT* | ***DECEMBER 31, 2008*** | *JUNE 30, 2008* |
|---|---|---|
| Bank indebtedness | **$3,355,898** | $1,611,246 |
| Working capital | **$2,817,970** | $2,855,092 |
| Long-term debt (long-term portion only) | **$1,268,060** | $875,580 |
| Shareholders' equity | **$16,873,628** | $16,716,344 |

## WORKING CAPITAL

At December 31, 2008, PSP's working capital was $2.8 million compared to $2.9 million at June 30, 2008, which is in line with management's expectations.

### Accounts Receivable

Accounts receivable at December 31, 2008 decreased $0.6 million to $5.2 million from $5.8 million at June 30, 2008. The decrease is primarily related to a reduction in sales during the current quarter as compared to the fourth quarter of last year.

### Inventory

Inventory at December 31, 2008 increased $1.3 million to $6.2 million compared to $4.9 million at June 30, 2008. The increase in inventory is primarily due to a significant increase in the Company's order intake during the quarter.

### Bank Indebtedness

The Company has in place a $5.0 million operating line of credit with a Canadian Chartered bank. At December 31, 2008 the Company had a balance of $3.7 million outstanding on this line of credit.

### Bank Covenants

At December 31, 2008 and June 30, 2008 , the Company was compliant with all covenants set out by its lenders.

**Investment Tax Credits Receivable (ITC)**
The Company has accumulated investment tax credits receivable relating to scientific research and development expenses incurred in previous periods. These ITC's will be used to reduce taxes payable in future periods. At December 31, 2008 the Company reported ITC's of $0.5 million (June 30, 208 - $0.1 million).

**Future Income Taxes**
At December 31, 2008, the Company had approximately $2.0 million in Canadian non-capital tax loss carry forwards available. The Company also had U.S. tax loss carry forwards of approximately $1.0 million USD of which $0.75 million have been recognized (June 30, 2008 - Canadian non-capital loss carry forwards were $1.4 million and U.S. tax loss carry forwards were $1.4 million USD.)

**PROPERTY, PLANT AND EQUIPMENT AND OTHER ASSETS**
During the quarter, the Company invested $0.2 million in property, plant and equipment, and $0.2 million in new product development costs and intangible assets.

**LONG-TERM DEBT**
The Company has a $1.5 million secured term loan with the Business Development Bank of Canada. During the quarter, the Company commenced repayment of this loan.

**EQUITY INSTRUMENTS AND CONTRIBUTED SURPLUS**
At December 31, 2008, PSP's issued and outstanding shares totaled 25,492,400 compared to 25,467,694 at June 30, 2008. The Company's Contributed Surplus balance totaled $1,218,848 at December 31, 2008, compared to $1,126,694 at June 30, 2008.

**OFF BALANCE SHEET FINANCING**
The Company does not have any significant off balance sheet financing arrangements and there were no significant changes in operating leases from those disclosed in the MD&A for the year ended June 30, 2008.

**RELATED PARTY TRANSACTIONS**
During the quarter the Company paid $nil (Q2 fiscal 2008 - $0.06 million) in consulting and professional fees to a company controlled by a significant shareholder and former director. These fees were charged to general and administration expense. These transactions were all in the normal course of operations and are measured at the exchange value (the amount of consideration established and agreed to by the related parties), which approximates the arm's length equivalent value.

**FINANCIAL INSTRUMENTS**
The Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate, credit and foreign currency risk. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

(a) At December 31, 2008, the Company had $3.7 million ( June 30, 2008 - $2.3 million) outstanding on its operating line of credit with a Canadian Chartered Bank.
(b) At December 31, 2008 the Company had $1.2 million (June 30, 2008 - $2.3 million) in accounts receivable due from the Canadian Federal government.
(c) At December 31, 2008 the Company had $nil (June 30, 2008 - $0.2 million) cash on deposit with a Canadian Chartered Bank and $0.4 million cash on deposit with a U.S. Bank (June 30, 2008 - $0.1 million).
(d) At December 31, 2008 the Company had $1.5 million ( June 30, 2008 - $1.0 million) outstanding on its variable rate secured term loan facility with the Business Development bank of Canada.
(e) Foreign currency exchange rate risk management - a portion of the Company's sales and cost of goods sold are denominated in foreign currencies and, accordingly, the related financial assets and liabilities are subject to fluctuations in exchange rates. The Company manages its exposure to foreign currency fluctuations by maintaining foreign currency bank accounts and receivables to offset foreign currency payables and planned expenditures. A change in foreign currency exchange rates could have a significant effect on the financial results of the Company.

**RISKS AND UNCERTAINTIES**
In the normal course of business, the Company's operations continue to be influenced by a number of internal and external factors, and are exposed to risks and uncertainties, that can affect its business, financial condition and operating results. The activities of the Company are subject to ongoing operational risks including the performance of key suppliers, product performance, government and other industry regulations, and reliance on information systems, all of which may affect the ability of the Company to meet its obligations. The ongoing ability to meet the needs of the market place is dependent on the development and introduction of new products. While management believes its innovation and technology make it a leader in the industry, revenue and results may be affected if products are not accepted in the market place, are not approved by regulatory authorities, or if products are not brought to market in a timely manner.

PSP operates in markets subject to government purchasing patterns and large tenders that are at times unpredictable and create fluctuations in the production load throughout the year. Government purchasing is typically tender driven and subject to competitive bidding. These buying patterns create the necessity of being able to quickly increase and decrease production capacity. PSP has addressed this by using cell based manufacturing in which production staff are grouped into cells. Cells can quickly be added or reduced in order to mitigate the impact of large contracts on regular production of core products. In addition, large contracts often create a situation where a significant portion of the Company's revenue and accounts receivable may be from a small number of customers increasing the risks of economic dependence and concentration of credit.

The Company's working capital position is dependent on the timely collection of accounts receivable, inventory management and scheduled supplier payments. A change in supplier payment terms or slow payment of accounts receivable could adversely affect the Company's liquidity. Management has implemented controls to ensure accounts receivable are current and suppliers payments are within terms.

Changing interest rates could have an effect on earnings. PSP's operating line, with a balance of $3.7 million and the Company's secured loan facility with a balance of $1.5 million at December 31, 2008, are variable rate loans. The effect of a 1% change in interest rates would have a nominal effect on the financial results of the company.

Foreign exchange rate fluctuations could lead to differences in the profitability of international contracts and orders. The majority of large international contracts are bid months in advance of when they are manufactured and shipped. These contracts are typically priced using United States dollars at an estimated future foreign exchange rate. If awarded to PSP, the receivables will generally be insured or secured by a letter of credit to ensure payment. If deemed necessary, management will enter into a foreign exchange forward contract to lock in the foreign exchange rate over the period of performance of these contracts. In addition, PSP reviews its price lists on a regular basis to ensure that it diminishes its exposure to rate changes. PSP manages its ongoing foreign currency exchange exposure by maintaining foreign currency bank accounts and receivables to offset foreign currency payables and planned expenditures. The nature of PSP's business allows the Company to naturally hedge future normal foreign currency payments with future normal foreign currency collections.

**MEASURES NOT IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES**

The following measure included in this report does not have a standardized meaning under Canadian generally accepted accounting principles and, therefore, is unlikely to be comparable to similar measures presented by other companies:

EBITDA (earnings before interest, income taxes, depreciation and amortization), while not a concept recognized by generally accepted accounting principles, is an indirect measure for operating cash flow, a significant indicator of the success of any business.

PSP™

**Pacific Safety Products Inc.**

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2008**

***PACIFIC SAFETY PRODUCTS INC.***
***CONSOLIDATED BALANCE SHEETS***

| ***AS AT*** | **DECEMBER 31, 2008** ***(UNAUDITED)*** | *JUNE 30, 2008* *(AUDITED)* |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS** | | |
| Accounts receivable (note 14) | **5,227,850** | 5,816,983 |
| Corporation taxes recoverable | **35,762** | 31,512 |
| Inventory (note 5) | **6,189,545** | 4,880,894 |
| Prepaid expenses and deposits | **296,753** | 196,389 |
| Investment tax credits receivable | **-** | 85,365 |
| Future income taxes recoverable (note 6) | **259,750** | 224,500 |
| Total Current Assets | **12,009,660** | 11,235,643 |
| **INVESTMENT TAX CREDITS RECEIVABLE** | **482,871** | - |
| **LONG TERM TAXES RECEIVABLE** | **16,999** | - |
| **FUTURE INCOME TAXES RECOVERABLE** (note 6) | **195,159** | 241,173 |
| **PROPERTY, PLANT AND EQUIPMENT** (note 7) | **1,844,208** | 1,682,758 |
| **PRODUCT DEVELOPMENT COSTS** (note 8) | **1,058,256** | 896,612 |
| **INTANGIBLE ASSETS** (note 9) | **3,272,004** | 3,462,068 |
| **GOODWILL** (note 9) | **8,454,221** | 8,454,221 |
| **TOTAL ASSETS** | **$ 27,333,378** | $ 25,972,475 |
| **LIABILITIES** | | |
| **CURRENT LIABILITIES** | | |
| Bank indebtedness (note 10) | **$ 3,355,898** | $ 1,611,246 |
| Accounts payable and accrued liabilities | **4,306,182** | 4,877,396 |
| Deferred revenue | **1,315,290** | 1,367,489 |
| Current portion of long-term debt (note 11) | **214,320** | 524,420 |
| Total Current Liabilities | **9,191,690** | 8,380,551 |
| **LONG-TERM DEBT** (note 11) | **1,268,060** | 875,580 |
| **TOTAL LIABILITIES** | **10,459,750** | 9,256,131 |
| **SHAREHOLDERS' EQUITY** | | |
| **EQUITY INSTRUMENTS** (note 12) | **17,519,787** | 17,504,223 |
| **CONTRIBUTED SURPLUS** (note 13) | **1,218,848** | 1,126,643 |
| **DEFICIT** | **(1,865,007)** | (1,914,522) |
| **TOTAL SHAREHOLDERS' EQUITY** | **16,873,628** | 16,716,344 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | **$ 27,333,378** | $ 25,972,475 |

**ON BEHALF OF THE BOARD OF DIRECTORS:**

John Brodie, Director          Martin Carsky, Director

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

***PACIFIC SAFETY PRODUCTS INC.***
***CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT***
***(UNAUDITED)***

| | ***THREE MONTHS ENDED DECEMBER 31, 2008*** | *THREE MONTHS ENDED DECEMBER 31, 2007* | ***SIX MONTHS ENDED DECEMBER 31, 2008*** | *SIX MONTHS ENDED DECEMBER 31, 2007* |
|---|---|---|---|---|
| **SALES** | **$ 9,592,792** | $ 7,282,922 | **$ 17,299,158** | $ 13,948,082 |
| **COST OF SALES** (note 5) | **7,182,685** | 5,954,997 | **13,016,029** | 11,113,827 |
| **GROSS MARGIN** | **2,410,107** | 1,327,925 | **4,283,129** | 2,834,255 |
| **EXPENSES** | | | | |
| Sales and marketing | **1,034,859** | 694,400 | **1,927,917** | 1,130,636 |
| Research and development | **55,534** | 17,684 | **131,183** | 129,365 |
| General and administration | **898,687** | 1,411,426 . | **1,721,235** | 2,362,976 |
| Interest on operating line | **36,979** | 35,010 | **70,972** | 35,010 |
| Interest on long-term debt | **8,176** | 18,148 | **44,243** | 43,312 |
| Foreign exchange losses | **134,357** | 16,739 | **149,917** | 31,450 |
| Amortization of property, plant and equipment | **47,909** | 51,492 | **91,641** | 95,551 |
| Amortization of intangible and other assets | **147,494** | 221,665 | **285,723** | 361,550 |
| Total Expenses | **2,363,995** | 2,466,564 | **4,422,831** | 4,189,850 |
| **INCOME (LOSS) BEFORE OTHER ITEMS** | **46,112** | (1,138,639) | **(139,702)** | (1,355,595) |
| **OTHER ITEMS** | | | | |
| Restructuring/Relocation expense (note 17) | **152,150** | 980,000 | **152,150** | 980,000 |
| Gain on sale of building (note 7) | **-** | (235,327) | **-** | (474,698) |
| **TOTAL OTHER ITEMS** | **152,150** | 744,673 | **152,150** | 505,302 |
| **NET LOSS BEFORE INCOME TAXES** | **(106,038)** | (1,883,312) | **(291,852)** | (1,860,897) |
| **INCOME TAXES** | | | | |
| Current | **6,624** | 105,219 | **(14,595)** | 218,662 |
| Future (note 6) | **(154,420)** | (624,048) | **(326,772)** | (834,032) |
| Total Income Taxes Recoverable | **(147,796)** | (518,829) | **(341,367)** | (615,370) |
| **NET INCOME (LOSS)** | **41,758** | (1,364,483) | **49,515** | (1,245,527) |
| **DEFICIT, BEGINNING** | **(1,906,765)** | (1,574,675) | **(1,914,522)** | (1,693,631) |
| **DEFICIT, ENDING** | **$ (1,865,007)** | $ (2,939,158) | **$ (1,865,007)** | $ (2,939,158) |
| ***EARNINGS (LOSS) PER SHARE*** ***BASIC AND FULLY DILUTED*** (note 12) | **$ 0.002** | $ (0.054) | **$ 0.002** | $ (0.050) |
| ***WEIGHTED AVERAGE COMMON SHARES ISSUED AND OUTSTANDING*** ***BASIC AND FULLY DILUTED*** | **25,467,694** | 25,091,728 | **25,467,694** | 24,677,351 |

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

***PACIFIC SAFETY PRODUCTS INC.***
***CONSOLIDATED STATEMENTS OF CASH FLOW***
***(UNAUDITED)***

| | ***THREE MONTHS ENDED DECEMBER 31, 2008*** | *THREE MONTHS ENDED DECEMBER 31, 2007* | ***SIX MONTHS ENDED DECEMBER 31, 2008*** | *SIX MONTHS ENDED DECEMBER 31, 2007* |
|---|---|---|---|---|
| **OPERATING ACTIVITIES** | | | | |
| Cash receipts from customers | **$ 9,388,594** | $ 6,441,529 | **$ 17,835,766** | $ 15,789,233 |
| Cash paid to suppliers and employees | **(9,967,934)** | (9,084,886) | **(18,881,759)** | (16,876,184) |
| Interest paid | **(45,155)** | (53,158) | **(115,215)** | (78,322) |
| Income taxes recovered | **(36,624)** | (213,103) | **(66,624)** | (213,103) |
| **CASH FLOW USED IN OPERATING ACTIVITIES** | **(661,119)** | (2,909,618) | **(1,227,832)** | (1,378,376) |
| **INVESTING ACTIVITIES** | | | | |
| Purchase of property, plant and equipment | **(244,371)** | (113,010) | **(357,461)** | (221,970) |
| Disposal of assets | **-** | - | **-** | 2,941,943 |
| Investment in new product development | **(151,643)** | (26,608) | **(248,321)** | (230,681) |
| Investment in intangible assets | **(1,907)** | (6,552) | **(8,982)** | (94,082) |
| Acquisition of APS Distributors Ltd., net of cash | **-** | (3,944,123) | **-** | (3,944,123) |
| **CASH FLOW USED IN INVESTING ACTIVITIES** | **(397,921)** | (4,090,293) | **(614,764)** | (1,548,913) |
| **FINANCING ACTIVITIES** | | | | |
| Proceeds from the issue of long-term debt | **-** | 1,000,000 | **100,000** | 1,000,000 |
| Repayment of long-term debt | **(17,620)** | - | **(17,620)** | (2,132,000) |
| Proceeds from the issue of equity instruments | **15,564** | 38,140 | **15,564** | 128,510 |
| **CASH FLOW FROM (USED IN) FINANCING ACTIVITIES** | **(2,056)** | 1,038,140 | **97,944** | (1,003,490) |
| **(INCREASE) IN BANK INDEBTEDNESS** | **(1,061,096)** | (5,961,771) | **(1,744,652)** | (3,930,779) |
| **CASH / (BANK INDEBTEDNESS), BEGINNING** | **(2,294,802)** | 2,919,136 | **(1,611,246)** | 888,144 |
| **BANK INDEBTEDNESS, ENDING** | **$ (3,355,898)** | $ (3,042,635) | **$ (3,355,898)** | $ (3,042,635) |

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

## *1. NATURE OF ACTIVITIES*

Pacific Safety Products Inc. ("PSP"), incorporated under the British Columbia Business Corporations Act, manufactures, distributes and sells a complete line of protective products and accessories for the defence and security market. Nexus Armour Inc. is a wholly owned subsidiary of PSP and is the parent company of Sentry Armor Systems Inc. ("Sentry"). Sentry was incorporated in the State of Delaware, USA and commenced operations in Dover, Tennessee on July 5, 2006. APS Distributors Ltd. ("APS") is a division of PSP located in Bedford, Nova Scotia and was acquired by PSP on October 31, 2007.

## *2. SIGNIFICANT ACCOUNTING POLICIES*

**Basis of Presentation**
The accompanying consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and includes the accounts of Pacific Safety Products Inc. and its wholly owned companies, Nexus Armour Inc., and Sentry Armor Systems Inc.. All intercompany transactions and balances are eliminated on consolidation.

These interim unaudited consolidated financial statements follow the same accounting policies and methods of application as the most recent audited consolidated financial statements dated June 30, 2008 except as disclosed in note 3. The disclosures provided herein are incremental to those included in the audited annual consolidated financial statements. These interim unaudited consolidated financial statements should be read in conjunction with the Company's June 30, 2008 audited annual consolidated financial statements.

**Use of Estimates**
The presentation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make assumptions and estimates that affect the reported amounts and other disclosures in these consolidated financial statements. Actual results may differ from those estimates.

**Goodwill and Intangible Assets**
Goodwill is reviewed by management annually or more frequently if an event or circumstances indicate that the asset might be impaired. When the carrying amount of a reporting unit exceeds its fair value, an impairment is recognized. Impairment is measured as the shortfall of the reporting unit's projected cashflows, after allocation to specific assets and liabilities, compared with the carrying amount of goodwill.

Patents, trademarks and deferred financing costs are recorded at out of pocket cost. Customer relationships, tradenames and non-compete agreements are recorded at cost which, for business acquisitions, represents the fair market value at the date of the acquisition. Management assesses intangible assets to ensure costs are recoverable through future sales. Any amount deemed to be unrecoverable is expensed. Amortization of intangibles is calculated using the following methods and annual rates:

| | |
|---|---|
| Deferred organization costs | straight-line over 5 years |
| Patents and trademarks | straight-line over 5 years |
| Customer relationships | straight-line over 10 to 15 years |
| Tradenames | straight-line over 15 years |
| Non-compete agreements | straight-line over 3 years |

**Measurement Uncertainty**
The amounts accrued to recognize investment tax credits and future income tax assets relating to unclaimed loss carry-forwards for income tax purposes are based on the Company's estimate that it will have sufficient future taxable income to utilize these losses. By their nature, these estimates are subject to measurement uncertainty and the effects of changes in estimates of judgments will be recorded in the period such changes are made.

Goodwill is reviewed by management annually or more frequently if an event or circumstance indicates that the asset might be impaired. When the carrying amount of a reporting unit exceeds its fair value an impairment is recognized in operations. Impairment is measured as the shortfall of the reporting unit's projected cashflows, after allocation to specific assets and liabilities, compared with the carrying amount of goodwill.

Management assesses intangible and other assets to ensure costs are recoverable through future sales less the costs to sell. Any amount deemed to be unrecoverable is recognized in the current period. By their nature, these estimates are subject to measurement uncertainty and the effects of changes in estimates of judgments will be recorded in the period such changes are made.

## 2. *SIGNIFICANT ACCOUNTING POLICIES (continued)*

The Company previously provided for certain warranty costs arising from the purchase of the net assets of Gator Hawk Armor Inc. ("GH"). Effective December 15, 2008, the Company reached an agreement with GH whereby the Company paid GH, $70,000 USD to settle and resolve all previous and future claims related to the replacement of GH products.

## 3. *CHANGE IN ACCOUNTING POLICY*

On July 1, 2008, the Company adopted the following Canadian Institute of Chartered Accountants ["CICA"] Handbook Sections:

**Section 3031, "Inventories"**
The new standard replaces the previous inventories standard and requires inventories to be valued on a first-in, first-out or weighted average basis, which is consistent with the Company's accounting policies. The new standard requires the measurement of inventories at the lower of cost and net realizable value and provides guidance on the determination of cost, including any write-down to net realizable value. The adoption of this standard has had no material impact on the financial position or results of operations as reported in the Company's unaudited interim consolidated financial statements. The Company values inventory at the lower of cost and net realizable value. The cost of finished goods includes direct costs and an allocation of fixed manufacturing overhead. Cost is determined on a weighted average basis.

**Section 3862, "Financial Instruments - Disclosures" and Section 3863, "Financial Instruments - Presentation"**
The new disclosure standards increase the Company's disclosure regarding the nature and extent of the risks associated with financial instruments and how those risks are managed. This new accounting standard is disclosed in note 14. Section 3863 carries forward, unchanged, the presentation standards from Section 3861.

**Section 1535, "Capital Disclosures"**
The new standard requires the Company to disclose its objectives, policies and processes for managing its capital structure. This new accounting standard is disclosed in note 15.

## 4. *RECENT ACCOUNTING PRONOUNCEMENTS*

As at July 1, 2009, the Company will be required to adopt the CICA Handbook Section 3064, "Goodwill and Intangible Assets", which will replace the existing Goodwill and Intangible Assets standard. The new standard revises the requirements for recognition, measurement, presentation and disclosure of intangible assets. The Company has evaluated the impact of this new standard and does not anticipate that the adoption of this new standard will have a material impact on the Company's financial position or results of operations.

In 2005, the Canadian Accounting Standards Board ("AcSB") announced that accounting standards in Canada are to converge with International Financial Reporting Standards ("IFRS"). On February 13, 2008, the AcSB had confirmed that the use of IFRS will be required by January 1, 2011, with appropriate comparative data from the prior year. Under IFRS, the primary audience is capital markets and as a result, there is significantly more disclosure required, specifically for quarterly reporting. Further, while IFRS uses a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy that must be addressed. While the Company has begun assessing the adoption of IFRS for 2011, the financial impact of the transition to IFRS cannot be reasonably estimated at this time.

## 5. *INVENTORY*

| | *December 31, 2008* | *JUNE 30, 2008* |
|---|---|---|
| Raw materials | **$ 4,854,275** | $ 3,714,900 |
| Work in process | **82,904** | 42,396 |
| Finished goods and samples | **1,252,366** | 1,123,598 |
| | **$ 6,189,545** | $ 4,880,894 |

## 5. *INVENTORY (continued)*

The following table sets forth details of Cost of Sales

| *For the six months ended December 31st* | **2008** | 2007 |
|---|---|---|
| Raw materials and consumables used | **$ 9,605,311** | $ 7,538,957 |
| Labour costs | **2,413,610** | 2,259,195 |
| Other costs | **997,108** | 1,315,675 |
| | **$ 13,016,029** | $ 11,113,827 |

## 6. *FUTURE TAX ASSETS*

| | ***December 31, 2008*** | *JUNE 30, 2008* |
|---|---|---|
| **Future Income Taxes Recoverable (Payable)** | | |
| **The major components of future income taxes recoverable (payable) are:** | | |
| Tax losses available to reduce future income taxes payable | **$ 295,000** | $ 295,000 |
| Allowance for tax losses available to reduce future income taxes payable | **(35,250)** | (70,500) |
| Current future income taxes recoverable | **259,750** | 224,500 |
| Temporary difference relating to deductible financing costs | **109,858** | 144,204 |
| Temporary differences relating to property, plant and equipment | **(125,260)** | (128,429) |
| Temporary differences relating to goodwill, intangibles and other assets | **(560,688)** | (498,809) |
| Deductible SR&ED expenditures available for future years | **43,747** | 174,411 |
| Deductible loss carryforwards available for future years | **727,502** | 549,796 |
| Non current future income taxes | **$ 195,159** | $ 241,173 |

The effective rate of income tax varies from the statutory rate as follows:

| *For the six months ended December 31* | **2008** | 2007 |
|---|---|---|
| Combined tax rates | **34%** | 34% |
| Income tax at the applicable tax rate | **$ (97,770)** | $ (623,400) |
| Effect of tax rate difference between Canada and US on US operations | **-** | 13,698 |
| Valuation allowance for tax losses available to reduce future income taxes payable | **(294,689)** | 65,560 |
| Income tax effect of items not deductible for tax purposes | **51,092** | 32,752 |
| Income tax effect of items not taxable for tax purposes | **-** | (103,980) |
| Actual income tax expense | **$ (341,367)** | $ (615,370) |

At December 31, 2008, the Company had approximately $2.0 million in Canadian non-capital tax loss carry forwards available. The Company has U.S. tax loss carry forwards of approximately $1.0 million USD of which $0.75 million have been recognized (June 30, 2008 - Canadian non-capital tax loss carry forwards were $1.4 million, U.S. tax loss carry forwards were $1.4 million USD).

## 7. PROPERTY, PLANT AND EQUIPMENT

| | December 31, 2008 | | | JUNE 30, 2008 | | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated Amortization | Net Book Value | Cost | Accumulated Amortization | Net Book Value |
| Office equipment | $ 296,915 | $ 134,623 | $ 162,292 | $ 273,535 | $ 118,048 | $ 155,487 |
| Manufacturing equipment | 2,228,777 | 1,236,404 | 992,373 | 2,030,072 | 1,141,401 | 888,671 |
| Computer equipment | 1,293,441 | 862,029 | 431,412 | 1,215,699 | 800,391 | 415,308 |
| Test and design equipment | 119,257 | 87,970 | 31,287 | 119,257 | 82,449 | 36,808 |
| Leasehold improvements | 277,443 | 50,599 | 226,844 | 224,258 | 37,774 | 186,484 |
| | $ 4,215,833 | $ 2,371,625 | $ 1,844,208 | $ 3,862,821 | $ 2,180,063 | $ 1,682,758 |

(a) Of the total amortization expense of $103,456 for the three month period ended December 31, 2008 ( December 31, 2007 - $103,960 ) there is $55,547 (December 31, 2007 - $52,468) recorded in Cost of Sales.

(b) During the three month period ended December 31, 2007 the company recorded a gain of $235,327 related to the disposition of it's building, excess land and parking lot in Kelowna, British Columbia.

## 8. PRODUCT DEVELOPMENT COSTS

| | December 31, 2008 | | | JUNE 30, 2008 | | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated Amortization | Net Book Value | Cost | Accumulated Amortization | Net Book Value |
| Product development costs | $ 1,361,822 | $ 303,566 | $ 1,058,256 | $ 1,113,366 | $ 216,754 | $ 896,612 |

## 9. GOODWILL AND INTANGIBLE ASSETS

| | DECEMBER 31, 2008 | | | JUNE 30, 2008 | | |
|---|---|---|---|---|---|---|
| | Cost | Accumulated Amortization | Net Book Value | Cost | Accumulated Amortization | Net Book Value |
| Deferred organization costs | $ 196,494 | $ 173,587 | $ 22,907 | $ 196,494 | $ 153,942 | $ 42,552 |
| Patents | 78,355 | 40,058 | 38,297 | 69,373 | 33,298 | 36,075 |
| Trademarks | 38,609 | 31,530 | 7,079 | 38,609 | 28,968 | 9,641 |
| Deferred financing costs | 111,879 | 111,879 | - | 111,879 | 111,826 | 53 |
| Customer relationships | 3,179,128 | 530,453 | 2,648,675 | 3,179,129 | 407,325 | 2,771,804 |
| Non-compete agreements | 171,273 | 105,867 | 65,406 | 171,273 | 77,321 | 93,952 |
| Tradenames | 550,531 | 60,891 | 489,640 | 550,531 | 42,540 | 507,991 |
| | 4,326,269 | 1,054,265 | 3,272,004 | 4,317,288 | 855,220 | 3,462,068 |
| Goodwill | 8,895,830 | 441,609 | 8,454,221 | 8,895,830 | 441,609 | 8,454,221 |
| | $ 13,222,099 | $ 1,495,874 | $ 11,726,225 | $ 13,213,118 | $ 1,296,829 | $ 11,916,289 |

## *10. BANK INDEBTEDNESS*

The Company has an agreement with a Canadian chartered bank to provide advances repayable on demand with interest payable monthly calculated at the bank prime lending plus 0.75% per annum. The loan is secured by a first priority general security agreement over accounts receivable, inventory and an assignment of insurance and is subject to a priority agreement between the Company and another financial institution. The maximum operating line is $5.0 million and is subject to margin requirements and covenants set by the lenders. At December 31, 2008 the amount drawn on the line of credit was $3,744,425 (June 30, 2008 - $2,268,503).

## *11. LONG-TERM DEBT*

| | DECEMBER 31, 2008 | *JUNE 30, 2008* |
|---|---|---|
| Subordinated debenture with interest payable monthly calculated at 14% per annum. There is also a deferred interest component calculated at 4% per annum, due annually, with an option to defer the payment to the maturity of the loan. The balance of the loan was due in July 2008 and was subject to annual principal repayments, based on a calculation of free cash flow, due 120 days after the year end. Management paid the maximum payment of $400,000 in fiscal 2008, the balance of the debenture due in fiscal 2009 is $400,000. and was paid in July 2008. | **$ -** | $ 400,000 |
| Secured loan with interest payable monthly calculated at the lender's floating base rate of 5.25% at December 31, 2008 plus a variance of 0.75% per annum on the principal outstanding. The principal is repayable by one installment of $17,620 on December 23, 2008, 83 consecutive monthly payments of $17,860 commencing January 23, 2009 with the final payment on November 23, 2015. This loan is secured by a first security interest in all present and after-acquired personal property, subject only to a prior charge with respect to receivables and inventory in favour of the lender providing the line of credit. | **1,482,380** | 1,000,000 |
| | **1,482,380** | 1,400,000 |
| Less current portion | **(214,320)** | (524,420) |
| | **$ 1,268,060** | $ 875,580 |

The estimated principal installments required to be paid over the five years are as follows:

| | |
|---|---|
| 2009 | $ 214,320 |
| 2010 | 214,320 |
| 2011 | 214,320 |
| 2012 | 214,320 |
| 2013 | 214,320 |
| Subsequent | 410,780 |
| | $ 1,482,380 |

## *12. EQUITY INSTRUMENTS*

***Authorized***
The authorized share capital of the Company consists of unlimited voting common shares without par value.

| *As at* | DECEMBER 31, 2008 | | *JUNE 30, 2008* | |
|---|---|---|---|---|
| | ***Number of Shares*** | ***Amount*** | ***Number of Shares*** | ***Amount*** |
| Beginning balance | **25,467,694** | **$ 17,504,223** | 24,197,964 | $ 16,356,195 |
| Employee Ownership Plan (a) | - | - | 20,995 | 18,513 |
| Exercise of options (b) | - | - | 238,500 | 123,817 |
| Shares issued on purchase of APS (c) | - | - | 1,000,000 | 1,000,000 |
| Employee Ownership Plan (d) | **24,706** | **15,564** | 10,235 | 6,448 |
| Less: stock issue costs, net of tax effect | - | - | - | (750) |
| **Balance,** | **25,492,400** | **$ 17,519,787** | 25,467,694 | $ 17,504,223 |

(a) In January 2007, the Company offered its seventh employee share ownership plan. Under the plan, employees were entitled to purchase up to 300,000 common shares at $0.90 per share, which was the trading price at the time of offering. As at June 30, 2007, 26,090 shares have been issued and 20,995 were issued during the period ending December 2007.
(b) During the year, the Company issued 238,500 common shares through the exercise of employee stock options for proceeds of $123,817.
(c) During the second quarter of fiscal 2008 the Company issued 1,000,000 common shares valued at $1 as part of the purchase consideration for the purchase of APS Distributors Ltd.
(d) In January 2008, the Company offered its eighth employee share ownership plan. Under the plan, employees were entitled to purchase up to 300,000 common shares at $0.63 per share, which was the trading price at the time of offering. As at March 31, 2008, 10,235 shares have been issued and 24,706 were issued during the period ending December 2008.

**Restricted Shares**
Effective March 13, 2007, the Company entered into a Restricted Share Agreement with an Employee. Subject to the terms and conditions of this Agreement, the Company agreed to grant Restricted Shares to the Employee on each of November 26, 2007, 2008 and 2009. The Restricted Shares granted in any year vest one year after the grant date and will be issued to the Employee on the second anniversary of the vesting date. The Company granted 62,000 and 100,000 Restricted Shares on November 26, 2007 and November 26, 2008, respectively, under the terms of this agreement.

**Stock Options**
The Company has a stock option plan that provides options to purchase common shares of the Company for its management, executive officers and members of the Board of Directors. These options expire five years after the issue date or, in the event the employee's service ceases, at a date determined by the Board of Directors. Board members' options expire 90 days after termination or resignation. The exercise price for these stock options is set at the average closing price over the previous 20 day trading period. Vesting periods are determined by the Board of Directors upon issuance. At December 31, 2008, the Company had 1,450,830 stock options outstanding with exercise prices ranging from $0.17 to $1.95. Of the options outstanding at December 31, 2008, 205,000 do not fully vest until one year after the grant date and/or specific conditions have been satisfied.

| | ***Senior Management*** | ***Executive Officers*** | ***Board of Directors*** | ***Total*** | ***Weighted Average Exercise Price*** |
|---|---|---|---|---|---|
| **Balance, June 30, 2008** | **50,000** | **504,330** | **561,500** | **1,115,830** | **$ 0.77** |
| **Issued** | **-** | **150,000** | **200,000** | **350,000** | **$ 0.36** |
| **Forfeited** | **-** | **-** | **(15,000)** | **(15,000)** | **$ 0.43** |
| **Balance, December 31, 2008** | **50,000** | **654,330** | **746,500** | **1,450,830** | **$ 0.68** |
| **Weighted Average Exercise Price** | **$ 0.76** | **$ 0.58** | **$ 0.76** | **$ 0.68** | |
| **Weighted Average Remaining Contractual Life (years)** | **2.19** | **2.15** | **3.07** | **2.68** | |
| **Total Stock Option Pool Authorized** | | | | | **3,000,000** |
| **Total Stock Option Pool Remaining** | | | | | **670,170** |

## *12. EQUITY INSTRUMENTS (continued)*

The fair value of stock options issued in previous years was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility ranged from (0.71 to 0.74), risk-free interest rate ranged from (2.3% to 3.85%), and weighted average life of five years. The fair value of stock options issued during the current year was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility ranging from (0.63 to 0.76), risk-free interest rate (4%), weighted average life of five years with a fair value ranging from ($0.11 to $0.28).

The following table summarizes information regarding the Company's outstanding stock options at December 31, 2008:

| | ***Options Outstanding*** | | | ***Options Exercisable*** | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number Outstanding | Weighted Average Remaining Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| $0.17 to $0.43 | 594,000 | 3.25 | $ 0.34 | 389,000 | $ 0.36 |
| $0.46 to $0.68 | 261,830 | 1.26 | $ 0.61 | 261,830 | $ 0.61 |
| $0.71 to $1.06 | 520,000 | 2.83 | $ 0.93 | 520,000 | $ 0.93 |
| $1.43 to $1.95 | 75,000 | 0.67 | $ 1.77 | 75,000 | $ 1.77 |
| | 1,450,830 | | $ 0.68 | 1,245,830 | $ 0.74 |

## *13. CONTRIBUTED SURPLUS*

| | |
|---|---|
| Balance, June 30, 2008 | $ 1,126,643 |
| Stock option compensation expense (a) | 100,705 |
| Stock option forfeited | (8,500) |
| **Balance, December 31, 2008** | **$ 1,218,848** |

(a) The fair value of stock options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility (0.74), risk-free rate (4.0%) and weighted average life of five years with a weighted average fair value of $0.24 per stock option.

## *14. FINANCIAL INSTRUMENTS*

In the normal course of business, the Company is exposed to a variety of financial risks related to credit, interest rate, currency fluctuations and liquidity.

**Credit Risk**
The Company sells its products to a variety of customers under various payment terms in the normal course of its operations and therefore is exposed to credit risk. The Company's exposure to credit risk is influenced by general economic conditions, the default risk of the industry and the relative concentration of business. A significant amount of the Company's trade receivables are derived from the Canadian federal government. At December 31, 2008 , the Company had $1.2 million (June 30, 2008 - $2.3 million) in accounts receivable due from the Canadian Federal government.

In monitoring credit risk, the Company considers industry, volume and aging trends, maturity, and other relevant factors. The Company performs ongoing credit evaluations of its customers' financial condition and limits the amount of credit extended when deemed necessary. Purchase limits established for certain accounts represent the maximum open balance permitted without approval from the Chief Financial Officer. The Company maintains reserves for potential credit losses relating to specific exposures and any such losses to date have been within management's expectations.

The maximum exposure to credit risk at the reporting date is the carrying value of receivables.

## *14. FINANCIAL INSTRUMENTS (continued)*

The movement in the allowance for doubtful accounts receivable in respect of trade receivable during the period was not significant. The following table sets forth details of accounts receivable:

| *As at* | **DECEMBER 31, 2008** | *JUNE 30, 2008* |
|---|---|---|
| Not past due | **$ 3,385,640** | $ 3,813,714 |
| Past due from more than one day but for no more than 30 days | **1,435,412** | 1,513,255 |
| Past due from more than 31 days but for no more than 60 days | **273,512** | 261,429 |
| Past due from more than 61 days | **177,362** | 253,241 |
| | **5,271,926** | 5,841,639 |
| Less: allowance for doubtful accounts | **44,076** | 24,656 |
| | **$ 5,227,850** | $ 5,816,983 |

**Interest Rate Risk**
The Company is exposed to interest rate risk with regard to a short-term variable rate operating line of credit and a long-term secured loan variable rate debt. For the three month period ended December 31, 2008, if interest rates on the operating line and long-term debt were to fluctuate by 1%, and all other variables were held constant, the impact on the Company's earnings before income taxes would be $12,000.

**Currency Fluctuations**
The Company operates primarily in North America and as a result, fluctuations in the rate of exchange between the US and Canadian dollar can have an effect on the Company's reported results.

A significant portion of the company's sales are denominated in Canadian dollars. Some of the companies raw material used in production and products purchased for resale are denominated in US dollars, and a significant portion of the Company's operational costs and expenses are incurred in Canadian dollars. Therefore, an increase in the value of the Canadian dollar relative to the US dollar reduces the revenue in Canadian dollar terms realized by the Company from sales made in US dollars, which reduces operating margin and the cash flow available to fund operations. The Company also has an investment in a US integrated operation, whose net assets are exposed to foreign currency translation risk.

For the three month period ended December 31, 2008, if the rate of exchange between the US and Canadian dollar were to fluctuate by 1%, and all other variables were held constant, the impact on the Company's earnings before income taxes would be $26,000.

**Liquidity Risk**
Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under normal and stressed conditions. The Company manages liquidity by having appropriate lines of credit available and monitoring cash requirements to meet expected operational expenses including debt service and capital requirements.

**Fair Value of Financial Instruments**
The Company's financial instruments consist of accounts receivable, demand operating loan, accounts payable and accrued liabilities and term loan. The fair values of accounts receivable, demand operating loan, accounts payable and accrued liabilities, as recorded in the consolidated balance sheets approximate their carrying amounts due to the short-term maturities of these instruments. The long-term secured term loan reflects current market interest rates and therefore the carrying amount approximate fair value.

### *14 FINANCIAL INSTRUMENTS (continued)*

The Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate, credit and foreign currency risk. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

(a) At December 31, 2008, the Company had $3.7 million ( June 30, 2008 - $2.3 million) outstanding on its operating line of credit with a Canadian Chartered Bank.

(b) At December 31, 2008 the Company had $1.2 million (June 30, 2008 - $2.3 million) in accounts receivable due from the Canadian Federal government.

(c) At December 31, 2008 the Company had $nil (June 30, 2008 - $0.2 million) cash on deposit with a Canadian Chartered Bank and $0.4 million cash on deposit with a U.S. Bank (June 30, 2008 - $0.1 million).

(d) At December 31, 2008 the Company had $1.5 million ( June 30, 2008 - $1.0 million) outstanding on its variable rate secured term loan facility with the Business Development bank of Canada.

(e) Foreign currency exchange rate risk management - a portion of the Company's sales are denominated in foreign currencies and, accordingly, the related financial assets and liabilities are subject to fluctuations in exchange rates. The Company manages its exposure to foreign currency fluctuations by maintaining foreign currency bank accounts and receivables to offset foreign currency payables and planned expenditures.

### *15. CAPITAL DISCLOSURES*

The Company's capital structure is comprised of Shareholders' equity and long-term debt. The Company's fundamental objective in managing capital is to ensure adequate liquidity and financial flexibility to meet its financial obligations and finance organic growth and acquisitions. The Company constantly monitors and assesses its financial performance in order to ensure that its net debt levels are prudent. When reviewing financing decisions, the Company considers the impact of debt and equity financing on its existing and future shareholders. The Company has established a committed revolving line of credit and long-term debt that provides liquidity.

| *16. SEGMENTED INFORMATION* | *Canadian Operations* | *US Operations* | *Consolidated Total* |
|---|---|---|---|
| ***For the six months ended December 31, 2008*** | | | |
| Revenue | $ 11,982,065 | $ 5,558,013 | $ 17,540,078 |
| Elimination of inter-segment revenue | (236,907) | (4,013) | (240,920) |
| Total revenue | 11,745,158 | 5,554,000 | 17,299,158 |
| Gross margin | 2,754,060 | 1,529,069 | 4,283,129 |
| Expenses | 2,745,945 | 1,299,522 | 4,045,467 |
| Amortization | 235,804 | 141,560 | 377,364 |
| Other Items | 152,150 | - | 152,150 |
| Income taxes | (175,168) | (166,199) | (341,367) |
| **Net income (loss) after taxes** | **$ (204,671)** | **$ 254,186** | **$ 49,515** |

### *16. SEGMENTED INFORMATION (continued)*

| *SEGMENTED INFORMATION* | *Canadian Operations* | *US Operations* | *Consolidated Total* |
|---|---|---|---|
| *For the six months ended December 31, 2007* | | | |
| Revenue | $ 11,237,560 | $ 2,992,925 | $ 14,230,485 |
| Elimination of inter-segment revenue | (149,826) | (132,577) | (282,403) |
| Total revenue | 11,087,734 | 2,860,348 | 13,948,082 |
| Gross margin | 2,343,915 | 490,340 | 2,834,255 |
| Expenses | 3,199,935 | 489,502 | 3,689,437 |
| Amortization | 315,585 | 141,516 | 457,101 |
| Other Items | 548,614 | - | 548,614 |
| Income taxes | (615,370) | - | (615,370) |
| **Net income (loss) after taxes** | $ (1,104,849) | $ (140,678) | $ (1,245,527) |

| *SEGMENTED INFORMATION* | *Canadian Operations* | *US Operations* | *Total* |
|---|---|---|---|
| **AS AT DECEMBER 31, 2008** | | | |
| *Assets* | | | |
| Current assets | **$ 8,806,498** | **$ 3,203,162** | **$ 12,009,660** |
| Property, plant and equipment | **1,205,313** | **638,895** | **1,844,208** |
| Intangible, Other assets, Future Income Tax | **3,314,931** | **1,710,358** | **5,025,289** |
| Goodwill | **5,459,017** | **2,995,204** | **8,454,221** |
| | **$ 18,785,759** | **$ 8,547,619** | **$ 27,333,378** |
| *AS AT JUNE 30, 2008* | | | |
| *Assets* | | | |
| Current assets | $ 9,124,644 | $ 2,110,999 | $ 11,235,643 |
| Property, plant and equipment | 1,229,495 | 453,263 | 1,682,758 |
| Intangible, Other assets, Future Income Tax | 2,754,631 | 1,845,222 | 4,599,853 |
| Goodwill | 5,459,017 | 2,995,204 | 8,454,221 |
| | $ 18,567,787 | $ 7,484,264 | $ 25,972,475 |

| ***Sales for the six months ended December 31*** | ***2008*** | *2007* |
|---|---|---|
| Domestic | **$ 12,186,127** | $ 11,136,224 |
| United States | **3,511,144** | 2,324,410 |
| International | **1,601,888** | 487,448 |
| | **$ 17,299,159** | $ 13,948,082 |

The Company operates primarily in the protective products and accessories manufacturing and distribution industry. Its current operations are based in Ontario and Nova Scotia, Canada and in Tennessee, USA. Included in Q2 revenue were sales of $1.8 million to the Canadian Federal Government (Q2 2008 - $1.5 million) which represents 18.8% (Q2 2008 - 20.0%) of total sales. Other than the Canadian Federal Government, the Company had no other significant sales (over 10% of revenue) to any one customer.

The Company experiences sales cycles that can be dependent on the award of contracts by major police agencies and federal government departments. These cycles are, at times, unpredictable and may cause variations in revenue and profitability from quarter to quarter.

## 17. *RELOCATION / RESTRUCTURING EXPENSES*

During the current quarter, the Company announced a restructuring plan directed at reducing costs through the reduction of non-production staff and the integration of APS. The Company has recorded a provision of $152,000 related to this activity.

During the second quarter of fiscal 2008, the Company announced it was moving its Corporate Head Office from Kelowna, BC to the Ottawa, ON region and to close the remaining manufacturing operation in Kelowna, BC . The Company recorded a provision of $980,000 related to this decision.

## 18. *CONTINGENCIES AND COMMITMENTS*

The Company entered into an agreement with its bank to secure an irrevocable Standby Letter of Credit (LOC) in the amount of $440,000 USD ($443,582 CAD) at December 31, 2007. The LOC is secured by the Company's operating line. This LOC is issued in connection with the Horizon 1 protective coverall contract as a security for payment to a certain supplier of raw materials.

Over the next five years, the Company is committed to operating leases in respect of its premises and equipment as follows:

| | |
|---|---|
| 2009 | $564,349 |
| 2010 | 554,008 |
| 2011 | 542,815 |
| 2012 | 516,353 |
| 2013 | 225,271 |
| Total | $2,402,796 |

## 19. *RELATED PARTY TRANSACTIONS*

During the quarter the Company paid $nil (Q2 fiscal 2008 - $58,944) in consulting and professional fees to a company controlled by a significant shareholder and former director. These fees were charged to general administration expense. These transactions were all in the normal course of operations and are measured at the exchange value (the amount of consideration established and agreed to by the related parties), which approximates the arm's length equivalent value.

PSP™

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