



Pacific Safety Products Inc.

REPORT TO SHAREHOLDERS

MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE
YEARS ENDED June 30, 2011 and 2010

Management's Discussion and Analysis

June 30, 2011 and 2010

(in thousands of Canadian dollars)

This Management's Discussion and Analysis ("MD&A") of the financial position and results of operations of Pacific Safety Products Inc. (the "Company" or "PSP") has been prepared as of October 24, 2011 and should be read together with the audited annual consolidated financial statements and the notes thereto for the year ended June 30, 2011, and the Joint Management Information Circular issued on November 24, 2010. 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. All figures are in **Canadian dollars except as otherwise noted**.

The financial data has been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") 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") website at www.sedar.com.

FORWARD-LOOKING INFORMATION

A number of the matters discussed in the MD&A deal with potential future circumstances and developments and may constitute "forward-looking" information within the meaning of applicable securities laws. These forward-looking statements relate to anticipated or assumed events or results including, without limitation, projected costs and capital expenditures, future tax losses, plans with respect to internal controls and the Company's outlook, business and capital management strategy, direction, plans, growth opportunities and objectives. Generally, forward-looking information can be identified as such because of the context of the statements and often include words or phrases such as "will", "believes", "anticipates", "predicts", "plans", "intends", "estimates", "expects", "continues", "is pursuing", "improving", "projects", "indicates", or words or phrases of a similar nature.

The forward-looking information is based on current expectations and assumptions regarding expected growth, results of operations, financial performance and business prospects and opportunities. Forward-looking information is subject to known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company, or general industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. These factors include, but are not limited to, the possible failure to successfully plan and execute business improvement strategies, restrictions and covenants contained in the Company's credit agreements, the potential impact of the current economic downturn on the Company's business, the unpredictability of purchasing patterns by governmental agencies, the possibility of a deterioration in the Company's working capital position, the impact that changes in supplier payment terms or slow payment of accounts receivable could have on the Company's liquidity, the unavailability of or increase in price of external capital to finance the Company's research, development and growth initiatives, changes in the laws, regulations, policies and economic conditions, including inflation, interest and foreign currency exchange rate fluctuations of countries in which the Company does business, competition in the Company's markets, successful integration of structural changes or downsizing initiatives, including restructuring plans, acquisitions, divestitures and alliances, cost of raw material, the uncertainty associated with the outcome of research and development of new products, including regulatory approval and market acceptance, and seasonality of sales in some products, as well as other factors described below under "Part VIII: Risks and Uncertainties" and the Company's other filings with applicable securities regulatory authorities which are available at www.sedar.com. The impact of any one risk factor on a particular forward-looking statement is not determinable with certainty as such factors are interdependent upon other factors, and management's course of action would depend upon its assessment of the future, considering all information then available.

Although the Company believes that the expectations and assumptions conveyed by the forward-looking information are reasonable based on information available to it as of October 24, 2011, no assurances can be given as to future results, levels of activity and achievements. All subsequent forward-looking information, whether written or oral, attributable to the Company or persons acting on its behalf, are expressly qualified in their entirety by these cautionary statements and readers are cautioned not to place undue reliance or importance on this information. The Company assumes no obligation to update forward-looking statements should circumstances or management's estimates or opinions change, except as required by applicable law.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Mission

...we bring everyday heroes home safely.™

This MD&A is organized into the following parts:

- I. Business Overview and Recent Events
- II. Results
- III. Cash Flow
- IV. Liquidity and Capital Resources
- V. Summary of Annual Information
- VI. Quarterly Results
- VII. Critical Accounting Estimates, Changes to Accounting Policies
- VIII. Risks and Uncertainties
- IX. Other Information

Part I: BUSINESS OVERVIEW AND RECENT EVENTS

Business Overview

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, where it is one of the largest soft body armour manufacturers. 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 be a preferred supplier of body armour and other personal protection solutions throughout North America.

PSP has a significant recurring revenue stream from its Canadian customers in the form of long 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 sold primarily through a network of third party distributors.

PSP has a research and development program that works cooperatively with customers on new product design. The Company also conducts independent research in future technologies and products that will enhance user effectiveness, increase value and survivability. PSP's current research and development programs are focused on the certification of certain product lines as required by the U.S. Department of Justice.

PSP has manufacturing operations in Arnprior, Ontario and Dover, Tennessee and its head office is located in Arnprior, Ontario. Its design and production facilities are all ISO9001:2008 registered and compliant to BA9000 (National Institute of Justice Body Armor Quality Management Requirements). Founded in 1984, PSP has grown to currently include more than 140 employees at its Canadian and U.S. facilities.

Recent Events

On August 31, 2011, PSP signed an agreement ("Agreement") with a major Canadian bank for a replacement credit facility in the amount of \$1.0 million. The new facility is secured by cash collateral of \$1.0 million and a general security agreement over all personal property of PSP and its subsidiaries. The Agreement has no financial covenants and is subject to certain general covenants as outlined in the Agreement. The Company is no longer operating under a forbearance agreement by virtue of having replaced its principal Canadian operating lender.

Previously, the Company signed a forbearance agreement (the "Forbearance Agreement") with its Canadian bank (the "Bank") on August 17, 2010. The Bank agreed, pursuant to the Forbearance Agreement, not to take steps to realize under the facility prior to February 28, 2011 (the "Forbearance Period") unless a terminating event as defined in the Forbearance Agreement occurs. In connection with the Forbearance Agreement, the Company notified the holder of long-term debt (the "Lender") and its U.S. operating lender. The Bank extended the Forbearance Period until maturity of the facility on August 31, 2011. During the Forbearance Period, the Company was subject to, and in compliance with, amended covenants.

A condition of the Company's Forbearance Agreement with its Bank required the Company to request from the Lender a six-month postponement of principal payments related to its long-term debt. The Lender agreed to this request pursuant to a letter agreement dated August 4, 2010. All other terms and conditions of the debt facility remain unchanged. Principal payments resumed on February 23, 2011.

On August 17, 2010, the Company issued a \$1 million unsecured convertible debenture in favour of a group of investors.

On October 20, 2010, the Company signed a letter of intent to complete a business combination by way of a court approved plan of arrangement (the "Plan of Arrangement") with Zuni Holdings Inc. ("Zuni"), an NEX listed company. On November 18, 2010, PSP and Zuni signed a definitive arrangement agreement (the "Arrangement Agreement") specifying the terms on which the Plan of Arrangement would be completed.

On December 31, 2010 pursuant to the Plan of Arrangement, PSP acquired all of the outstanding common shares of Zuni in exchange for PSP common shares at an agreed exchange ratio of one PSP common share for each Zuni common share. Zuni was amalgamated with a wholly-owned subsidiary of PSP incorporated for the purpose of carrying out the Plan of Arrangement. The amalgamated entity was continued as Zuni Holdings Inc., a subsidiary of PSP. The transaction has been accounted for as the acquisition of the assets and liabilities of Zuni in exchange for PSP common shares valued at the effective date of the acquisition.

This transaction strengthened the capital position of PSP and is expected to allow it to take advantage of growth opportunities available to the Company. Restricted cash of \$2.5 million was released on June 11, 2011. The working capital ratio at June 30, 2011, is 1.69 compared to 1.05 at June 30, 2010. The debt to tangible net worth ratio at June 30, 2011 is 1.59 compared to 9.06 at June 30, 2010. The debt to tangible net worth ratio does not have a standardized meaning as prescribed by GAAP. The Company defines debt as total liabilities less convertible debentures, and tangible net worth as the sum of shareholders' equity and convertible debentures less intangible assets and product development costs.

On May 5, 2011, the Company completed the sale of certain assets of APS Distributors, a division of PSP located in Bedford, Nova Scotia for a purchase price of \$500,000 before transaction costs. Proceeds of the sale, net of an \$18,000 holdback, have been used to reduce debt obligations.

Throughout the last year the Company has successfully implemented many other significant steps in its business transformation process including: building a new management team, setting a clear strategic direction built around personal protection solutions, building out its NIJ.06-certified body armour product portfolio, sub-letting its former head office space in Kanata, upgrading its quality assurance processes, implementation of continuous improvement programs throughout the Company, and working closely with its customers and suppliers among other achievements.

The Company's ability to continue as a going concern and to realize the carrying value of its assets and discharge its liabilities when due is dependent upon the Company's ability to restore profitable operations and raise additional capital.

Part II: RESULTS

SUMMARY OF OPERATIONS	YEAR ENDED JUNE 30, 2011	YEAR ENDED JUNE 30, 2010	YEAR ENDED JUNE 30, 2009
SALES	\$ 22,663,696	\$ 29,989,255	\$ 35,035,486
COST OF SALES	17,670,900	24,079,235	26,580,658
GROSS MARGIN	4,992,796	5,910,020	8,454,828
EXPENSES	6,478,406	7,370,074	8,405,661
INCOME (LOSS) BEFORE OTHER ITEMS	(1,485,610)	(1,460,054)	49,167
OTHER ITEMS	1,896,381	1,656,783	9,078,617
LOSS BEFORE INCOME TAXES	(3,381,991)	(3,116,837)	(9,029,450)
INCOME TAX EXPENSE (RECOVERY)	-	(67,655)	181,212
NET AND COMPREHENSIVE LOSS	\$ (3,381,991)	\$ (3,049,182)	\$ (9,210,662)
BASIC AND DILUTED LOSS PER SHARE	\$ (0.083)	\$ (0.119)	\$ (0.361)
WEIGHTED AVERAGE BASIC COMMON SHARES ISSUED AND OUTSTANDING - BASIC AND DILUTED	40,976,048	25,690,173	25,486,166
FINANCIAL POSITION	JUNE 30, 2011	JUNE 30, 2010	JUNE 30, 2009
TOTAL ASSETS	\$ 10,326,498	\$ 12,140,618	\$ 15,500,340
TOTAL LONG-TERM FINANCIAL LIABILITIES	\$ 1,568,073	\$ 946,580	\$ 1,160,900

Sales

Sales for the year ended June 30, 2011 were \$22.7 million, a decrease of \$7.3 million or 24.4% as compared to the prior year. The decrease is attributed to a decline in the distribution business and core law enforcement sales in both Canada and the United States. Sales to Canadian customers for the year ended June 30, 2011 were \$13.4 million, a decline of \$6.6 million or 33.1% compared to the prior year. The decrease is primarily attributed to the decline in the distribution business and contract timing, partially offset by an increase in contract sales to the Canadian Department of National Defence ("DND"). Sales to U.S. and International customers for the year ended June 30, 2011 were \$9.3 million, a decrease of \$0.7 million or 7.2% compared to the prior year. The decrease is primarily related to a reduction in international law enforcement sales, partially offset by a significant General Services Administration ("GSA") contract in fiscal 2011.

Gross Margin

For the year ended June 30, 2011, gross margin as a percentage of sales was 22.0%, which was an increase over gross margin of 19.7% during the prior year. The increase is primarily related to product mix and inventory write-offs in the prior year.

Expenses

For the year ended June 30, 2011, expenses were \$6.5 million, a decrease of \$0.9 million or 12.1% as compared to the prior year. The decrease in expenses is primarily related to cost reduction initiatives implemented over the last 12 months, partially offset by expenses related to the entities acquired pursuant to the Plan of Arrangement.

For the year ended June 30, 2011, sales and marketing expenses were \$2.0 million as compared to \$2.8 million during the prior year. The decrease is primarily related to a reduction in head count and other cost reduction initiatives compared to the prior year.

For the year ended June 30, 2011, research and development expenses were \$0.3 million as compared to \$0.2 million during the prior year. The development costs expense is primarily related to the development and certification of certain product lines in accordance with U.S. Department of Justice standards.

For the year ended June 30, 2011, general and administration expenses were \$3.4 million as compared to \$3.5 million during the prior year. A reduction in head count was offset by increased consulting and professional fees and a stock-based compensation expense of \$0.1 million.

Other Items

For the year ended June 30, 2011, interest expense on bank indebtedness was \$0.1 million, a decrease from \$0.2 million during the prior year due to lower utilization. For the year ended June 30, 2011, interest expense on the long-term debt was \$0.06 million, consistent with the prior year.

For the year ended June 30, 2011, accrued interest on convertible debentures issued on August 17, 2010 was \$0.09 million and the Company recorded an interest expense for accretion of the convertible debentures of \$0.09 million.

On May 5, 2011, the Company recorded a loss of \$1.5 million from the sale of certain assets of APS Distributors, a division of PSP located in Bedford, Nova Scotia.

On June 15, 2010, the Company announced its intent to sell its headborne system assets. During the year ended June 30, 2010, the Company recorded a loss of approximately \$0.6 million to write down these assets to their fair value less costs to sell and a further loss related to the sale of these assets of \$0.04 million during the year ended June 30, 2011.

Income Taxes

Income tax expense 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, the tax benefit of losses not recognized and other items.

Net and Comprehensive Loss

For the year ended June 30, 2011, the Company recorded a net and comprehensive loss of \$3.4 million as compared to a net and comprehensive loss of \$3.0 million during the prior year. The increase in net and comprehensive loss is primarily due to the loss on sale of APS assets in 2011 being higher than the loss on sale of the Headborne assets and write-down of investment tax credits recoverable recorded in fiscal 2010.

Adjusted Earnings Before Interest, Taxes, Depreciation and Amortization ("Adjusted EBITDA")

Adjusted EBITDA is not a recognized performance measure under GAAP and does not have a standardized meaning prescribed by GAAP. The term EBITDA consists of net and comprehensive loss and excludes interest, income tax expense (recovery), depreciation and amortization. Adjusted EBITDA excludes stock-based compensation and one-time costs. Adjusted EBITDA is included as a supplemental disclosure because management believes that such a measurement provides a better assessment of the Company's operations on a continuing basis by eliminating certain non-cash charges and charges that are nonrecurring. The most directly comparable measure to Adjusted EBITDA calculated in accordance with GAAP is net and comprehensive income (loss). The following is a reconciliation of the Company's Adjusted EBITDA to net and comprehensive loss.

For the year ended June 30, 2011 Adjusted EBITDA was a loss of \$0.4 million compared to an Adjusted EBITDA loss of \$0.5 million during the prior year.

The following is a reconciliation of Net and Comprehensive Loss to Adjusted EBITDA:

	YEAR ENDED JUNE 30, 2011	YEAR ENDED JUNE 30, 2010	YEAR ENDED JUNE 30, 2009
Net and comprehensive loss	\$ (3,381,991)	\$ (3,049,182)	\$ (9,210,662)
Interest expense, net	352,559	268,890	206,977
Income taxes (recovery)	-	(67,655)	181,212
Stock-based compensation	113,226	17,185	167,795
Amortization	942,554	971,132	1,019,238
Restructuring/relocation costs	-	188,545	417,419
Loss on assets held for sale	1,543,822	609,422	-
Write-down of investment tax credits recoverable	-	589,926	-
Goodwill impairment charge	-	-	8,454,221
Adjusted EBITDA	\$ (429,830)	\$ (471,737)	\$ 1,236,200

Part III: CASH FLOW

CASH FLOW FROM (USED IN)	YEAR ENDED JUNE 30, 2011	YEAR ENDED JUNE 30, 2010	YEAR ENDED JUNE 30, 2009
Operating activities	\$ (939,134)	\$ 1,431,446	\$ 19,220
Investing activities	467,711	(896,554)	(1,144,435)
Financing activities	3,369,158	(754,874)	687,940
	\$ 2,897,735	\$ (219,982)	\$ (437,275)

Cash flow used in operating activities for the year ended June 30, 2011 was \$0.9 million as compared to cash flows from operating activities of \$1.4 million during the prior year. The increased use of cash in operating activities is primarily due to the decline in sales, funding of losses and the reduction in days payables outstanding.

Cash flow from investing activities for the year ended June, 2011 was \$0.5 million as compared to cash flow used in investing activities of \$0.9 million during the prior year. The increase in cash flow was due to proceeds from the sale of assets and reduced investment in property and equipment and new product development compared to the prior year.

Cash flow from financing activities for the year ended June 30, 2011 was \$3.4 million as compared to cash flow used in financing activities of \$0.8 million during the prior year. The increase in cash flow is due to cash proceeds from the Plan of Arrangement, net of share issue costs of \$1.6 million, release of restricted cash of \$2.6 million and net proceeds from the issue of convertible debentures of \$0.9 million, offset by a reduction in bank indebtedness of \$1.7 million and repayment of long-term debt of \$0.1 million.

Part IV: LIQUIDITY AND CAPITAL RESOURCES

AS AT	JUNE 30, 2011	JUNE 30, 2010
Cash and cash equivalents	\$ 2,897,735	\$ -
Bank indebtedness	(693,026)	(2,410,390)
Working capital (excluding assets held for sale)	2,868,874	98,489
Long-term debt (long-term portion only)	(839,420)	(946,580)
Convertible debentures	(728,653)	-
Shareholders' equity (deficiency)	(4,628,372)	(4,634,541)

The Company's objective when managing liquidity and capital resources is to ensure that it has sufficient liquidity to support its financial obligations and fund its operating and strategic objectives.

The Company's operations and capital expenditures are primarily financed through the use of its credit facilities and working capital. The Company cannot conclude that existing cash resources, together with cash expected to be generated by operations, will be sufficient to meet operational and capital expenditure requirements and meet working capital needs, for at least the next 12 months based on current projections. The Company anticipates minimal capital expenditures in 2012 primarily related to ongoing repairs and maintenance. In order to address the Company's cash requirements, the merger with Zuni was completed by way of a Plan of Arrangement effective December 31, 2010.

The Company cannot predict the amount or timing of its need for additional funds under various circumstances, such as continuing operations, new product development, changes to capital structure, or the continued weakness in economic conditions affecting the sectors within which the Company operates. There can be no assurance that, if deemed necessary, additional credit facilities could be obtained in order to permit the repayment of indebtedness under the Company's existing credit facilities, or that, if such a replacement facility was obtained, it could be obtained at costs, or on terms and conditions comparable to those of the Company's current indebtedness.

Working Capital

At June 30, 2011, PSP's working capital was \$2.9 million compared to \$0.1 million (excluding assets held for sale) as at June 30, 2010. The increase in working capital is primarily related to the acquisition of net assets of Zuni, including cash and cash equivalents of \$2.8 million as at June 30, 2011.

Accounts receivable as at June 30, 2011 were \$2.4 million compared to \$4.2 million as at June 30, 2010. The level of accounts receivable at June 30, 2011 reflects the reduction in 4th quarter sales compared to the same period in the prior year.

Inventory as at June 30, 2011 decreased by \$1.0 million to \$1.3 million as compared to \$2.3 million as at June 30, 2010. This decrease is primarily related to reduced sales volume and sale of the APS Distributors division in May 2011.

Accounts payable and accrued liabilities as at June 30, 2011 were \$3.0 million compared to \$3.8 million as at June 30, 2010. The decrease reflects the reduction in inventory, expenses, and days payables outstanding, offset by the balance of Zuni liabilities assumed of \$0.9 million as at June 30, 2011.

Bank Indebtedness

PSP had an agreement with the Bank to provide advances repayable on demand with interest payable monthly calculated at the bank prime lending rate plus 3.50% per annum. The loan was secured by a first priority general security agreement over Canadian accounts receivable and inventory. The maximum operating line was \$3.0 million, reduced to \$1.0 million following the sale of the APS Distributors division and the release of cash being held in escrow, and was subject to margin requirements and covenants set by the Bank. At June 30, 2011, the amount drawn on the line of credit was \$0.7 million (June 30, 2010 - \$1.9 million). The Company signed the Forbearance Agreement with the Bank on August 17, 2010 and the Bank extended the Forbearance Period until maturity of the facility on August 31, 2011.

PSP signed an Agreement with another Canadian bank on August 31, 2011 for a replacement credit facility in the amount of \$1.0 million. The new facility is a revolving demand facility available by way of overdraft with interest payable monthly calculated at the bank prime lending rate plus 1.95% per annum. The facility is secured by cash collateral of \$1.0 million and a general security agreement over all personal property of PSP and its subsidiaries. The Agreement has no financial covenants and is subject to certain general covenants as outlined in the Agreement.

Sentry has an agreement with a United States bank to provide advances repayable on demand with interest payable monthly calculated at the bank prime lending rate plus 2.00% per annum. The loan is secured by a first priority general security agreement over U.S. accounts receivable, inventory and an assignment of insurance. The maximum operating line is \$1.4 million USD and is subject to margin requirements and covenants set by the lenders. At June 30, 2011, the amount drawn on the line of credit was \$Nil (June 30, 2010 - \$0.5 million).

Long-term Debt

The Company has a \$1.4 million secured term loan with the Business Development Bank of Canada ("BDC" or the "Lender"). A condition of the Company's Forbearance Agreement with its Bank required the Company to request from BDC a six-month postponement of principal payments related to its long-term debt. BDC agreed, pursuant to a letter agreement dated August 4, 2010, to this request. All other terms and conditions of the debt facility remain unchanged. Principal payments resumed on February 23, 2011. At June 30, 2011, the principal outstanding on the loan was \$1.1 million.

Convertible Debentures

On August 17, 2010, the Company completed a private placement for gross proceeds of \$1,000,000. Pursuant to the private placement, the Company issued 40 units (the "Units") at a purchase price of \$25,000 per Unit. Each Unit consisted of \$25,000 in principal amount of unsecured convertible debentures (the "Debentures") and 62,500 detachable common share purchase warrants (the "Warrants").

The Debentures mature three years from the date of issuance and bear interest at a rate of 10% per annum, payable annually in cash or common shares at the option of the Company. The Company elected to settle interest payable on convertible debentures as of August 17, 2011 in the amount of \$100,000 with the issuance of 1,145,408 common shares. The holder has the right to convert all (but not less than all), principal and accrued interest at any time to common shares at a rate of one common share per \$0.10 of indebtedness.

The Warrants have a one-year term with an exercise price of \$0.10 per common share during the first six-months and an exercise price of \$0.12 per common share during the second six-months of the term. The Warrants expired unexercised on August 17, 2011.

Certain Directors of the Company beneficially own or control, directly or indirectly, \$750,000 aggregate principal amount of the Debentures and 1,875,000 Warrants.

The Debentures contain certain default provisions that would provide the holders the right to demand repayment. The Company was in compliance with these conditions at June 30, 2011.

Future Income Taxes

At June 30, 2011, the Company had approximately \$4.3 million in Canadian tax non-capital loss carryforwards and \$2.9 million in U.S. tax loss carryforwards available, excluding loss carryforwards of Zuni and its subsidiaries which have no operating business activities. As at June 30, 2011, the Company increased its income tax valuation allowance to \$6.9 million from \$3.0 million at June 30, 2010. The increase is related to the valuation allowance against loss carryforwards of Zuni and its subsidiaries and the lack of profitability of the Company in the past several years.

Equity Instruments and Other Paid-in Capital

At June 30, 2011, the Company's issued and outstanding shares were 56,309,487. At June 30, 2010, the Company's issued and outstanding shares were 25,741,153. On December 31, 2010, 30,468,334 common shares were issued to Zuni shareholders in exchange for Zuni shares at an agreed exchange ratio of one PSP common share for each Zuni common share. The value ascribed to the PSP common shares issued under the Plan of Arrangement was \$2.5 million, net of share issue costs. On January 27, 2011, the Company issued 100,000 restricted shares in accordance with the terms and conditions of a Restricted Share Agreement with an employee.

The Company's contributed surplus balance was \$1.8 million at June 30, 2011 compared with \$1.2 million at June 30, 2010. The excess of the value of Zuni net assets acquired over the purchase consideration was accounted for as a credit to contributed surplus in the amount of \$0.4 million. The fair value of 2,000,000 PSP replacement stock options issued to Zuni option holders of \$0.1 million was credited to contributed surplus. Stock-based compensation expense related to stock options issued in the third quarter of fiscal 2011 was \$0.1 million.

Other paid-in capital of \$0.3 million at June 30, 2011 reflects the allocation of the equity component of convertible debentures, net of issue costs.

Contractual Obligations

The Company has obligations under long-term operating leases for premises and office equipment for various periods up to May, 2017.

Future minimum annual lease payments over the next five years and thereafter are as follows:

2012	\$	545,037
2013		596,489
2014		518,247
2015		464,911
2016		464,911
Thereafter		426,169
	\$	<u>3,015,764</u>

On August 16, 2011, the Company signed a sublease for its former head office premises in Kanata, Ontario. As a result of entering this sublease, future operating lease commitments included above will be reduced by \$438,000.

Capital Management

The Company's capital management strategy is designed to maintain financial strength and flexibility to support profitable growth. The Company's capital consists of accumulated debt, which is comprised of long-term debt, convertible debentures, bank indebtedness and shareholders' equity, excluding other comprehensive income (loss). The Company manages its capital structure and makes adjustments to it, based on the level of funds available to the Company to manage its operations. See "Bank Indebtedness", "Long-term Debt" and "Convertible Debentures".

The Company has not established a quantitative return on capital criteria; but rather promotes year-over-year sustainable growth.

The Company must adhere to certain financial covenants related to debt. See "Bank Indebtedness", "Long-term Debt" and "Convertible Debentures".

There have been no changes in the Company's approach to capital management during the year.

Part V: SUMMARY OF ANNUAL INFORMATION

(In Canadian dollars, except per share amounts)	Year ended June 30, 2011	Year ended June 30, 2010	Year ended June 30, 2009
Sales	\$ 22,663,696	\$ 29,989,255	\$ 35,035,486
Net and comprehensive loss for the year	(3,381,991)	(3,049,182)	(9,210,662)
Basic and diluted loss per share	(0.083)	(0.119)	(0.361)
Total assets	10,326,498	12,140,618	15,500,340
Total long-term financial liabilities	1,568,073	946,580	1,160,900

Part VI: QUARTERLY RESULTS

Fiscal 2011

	June 30, 2011	March 31, 2011	December 31, 2010	September 30, 2010
Sales	\$ 4,943,820	\$ 8,286,012	\$ 5,094,773	\$ 4,339,091
Net and comprehensive loss	(2,115,994)	(140,687)	(359,734)	(765,576)
Basic and diluted loss per share	(0.038)	(0.002)	(0.014)	(0.030)

Fiscal 2010

	June 30, 2010	March 31, 2010	December 31, 2009	September 30, 2009
Sales	\$ 7,125,500	\$ 7,731,869	\$ 7,472,312	\$ 7,659,574
Net and comprehensive loss	(2,439,037)	(87,378)	(158,984)	(363,783)
Basic and diluted loss per share	(0.095)	(0.003)	(0.006)	(0.014)

Fourth Quarter 2011

Sales

Sales for the three months ended June 30, 2011 were \$4.9 million, a decrease of \$2.2 million or 30.6% compared to the same period in the prior year. The decrease is primarily attributed to the decline in core law enforcement sales in Canada and the sale of the APS Distributors division on May 5, 2011.

Gross Margin

For the three months ended June 30, 2011, gross margin as a percentage of sales was 24.2%, a significant increase over the gross margin of 17.7% during the same period in the prior year. The increase is primarily related to product mix and inventory write-offs during the three months ended June 30, 2010 due to delays in DND programs.

Expenses

Total expenses were \$1.7 million for the three months ended June 30, 2011 compared to \$2.1 million for the same period in the prior year. The decrease is primarily attributable to the inclusion of certain one-time general and administration costs in the three months ending June 30, 2010 relating to an arrangement agreement that was terminated.

Other Items

Total other items were \$1.6 million for the three months ended June 30, 2011 compared to \$1.4 million for the same period in the prior year. The Company recorded a loss on sale of certain assets of the APS Distributors division of \$1.5 million during the three months ended June 30, 2011. Other items for the three months ended June 30, 2010 included a loss on sale of headbourne system assets of \$0.6 million and a write-down of investment tax credits recoverable of \$0.6 million.

Significant Fluctuations in Quarterly Results

For the three months ended June 30, 2011, the Company recorded a loss from operations of \$2.1 million or \$0.038 per share. The increase in the loss compared to the prior quarter is primarily due to the reduction in sales and gross margin and the loss on sale of APS assets of \$1.5 million.

For the three months ended March 31, 2011, the Company recorded a loss from operations of \$0.1 million or \$0.002 per share. The decrease in the loss compared to the prior quarter is primarily due to increased sales and gross margin partially offset by an increase in general and administration expenses. The decrease in loss per share reflects the anti-dilutive effect of the issue of 30,468,344 common shares on December 31, 2010 pursuant to the Plan of Arrangement.

For the three months ended December 31, 2010, the Company recorded a loss from operations of \$0.4 million or \$0.014 per share. The decrease in the loss compared to the prior quarter is primarily due to increased sales and gross margin and a reduction in sales and marketing expenses.

For the three months ended September 30, 2010, the Company recorded a loss from operations of \$0.8 million or \$0.030 per share. The decrease in the loss compared to the prior quarter is primarily due to a loss on sale of assets of \$0.6 million and a write-down of investment tax credits recoverable of \$0.6 million for the three months ended June 30, 2010.

For the three months ended June 30, 2010, the Company recorded a loss from operations of \$2.4 million or \$0.095 per share. The increase in the loss compared to the prior quarter is primarily due to the reduction in sales and gross margin, costs associated with the Arrangement Agreement and the Headborne sale, and the write-down of investment tax credits.

Part VII: CRITICAL ACCOUNTING ESTIMATES, CHANGES TO ACCOUNTING POLICIES

Critical Accounting Estimates

The Company's significant accounting policies are described in note 2 to the consolidated financial statements. Management believes that the policies which are most subject to estimation and management's judgment are outlined below.

Property and Equipment

Amortization is recorded on property and equipment at rates ranging from 20% to 30% of the diminishing balance per year, based on the determination of their estimated useful lives. This determination is based on management's estimates.

Product Development Costs

The Company recognizes certain costs related to the design and development of a modified or new product or process as an intangible asset if it is probable the expected future economic benefits attributable to the asset will flow to the Company and the cost can be measured reliably.

Intangible Assets

Amortization is recorded on acquired customer relationships, trade names and other intangibles on a straight-line basis over 3 to 15 years, which are the estimated useful lives of the assets. This determination is based on management's estimates.

Future Tax Asset

The Company has a future tax asset of \$Nil. At June 30, 2011, the Company had approximately \$4.3 million in Canadian tax non-capital tax loss carryforwards and \$2.9 million of U.S. non-capital tax loss carryforwards available to reduce taxable income in future years. If the Company is able to generate sufficient taxable income to use these non-capital loss carryforwards, and to otherwise qualify according to local tax laws, then future tax expense on future years' taxable income could be reduced below the expected statutory amounts. The unused tax losses will expire between 2026 and 2031.

Other Estimates

Significant management estimates are found in the impairment analysis and useful lives of intangible assets, property and equipment and product development costs. By their nature, these estimates are subject to measurement uncertainty and the effects of changes in estimates and judgments will be recorded in the period such changes are made.

Future Changes in Accounting Standards

Convergence to International Financial Reporting Standards ("IFRS")

In February 2008, the CICA's Accounting Standards Board ("AcSB") announced that Canadian public companies will be required to adopt IFRS as issued by the International Accounting Standards Board ("IASB") effective January 1, 2011. The changeover date applies to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011.

Key IFRS dates for the Company:

- July 1, 2010 (transition date): The Company will prepare an opening statement of financial position according to IFRS, as at this date, to facilitate the changeover to IFRS in fiscal 2012.
- July 1, 2011 (changeover date): the date after which the Company will prepare and report interim and annual 2012 financial statements according to IFRS with 2011 comparatives also according to IFRS.

This information is provided to allow investors and others to obtain a better understanding of the Company's IFRS changeover plan and the resulting possible effects on, for example, the financial statements and operating performance measures. Readers are cautioned that it may not be appropriate to use such information for any other purpose. This information reflects our most recent assumptions and expectations. Circumstances may arise, such as changes in IFRS, regulations, or economic conditions which could change these assumptions or expectations.

The following outlines the Company's conversion plan:

Key Activity	Key Milestones	Status
IFRS Conversion Scoping Phase	Review of current Canadian Generally Accepted Accounting Principles ("GAAP") standards versus IFRS. Identification of significant differences.	The review is complete and the determination of financial statement impact is completed.
Decisions on Accounting Policies and IFRS 1 <i>First-Time Adoption</i>	Assessment of differences between IFRS and the Company's current Canadian GAAP practices and accounting policies. Decision on accounting policy choices and IFRS 1 for each assessed area.	The Company has completed the assessment of differences during fiscal 2011. The Company has initiated the decision-making process on accounting policy choices and IFRS 1 <i>First-Time Adoption</i> exemptions and exceptions for each area.
Information Technology (IT) Evaluation	Identification of IT requirements for IFRS conversion.	The Company has identified the IT requirements for IFRS conversion. Plans are in place to capture fiscal 2011 results in IFRS in addition to Canadian GAAP.
Control Environment: Internal Control over Financial Reporting ("ICOFR") and Disclosure Controls and Procedures ("DC&P")	Review and assessment of impact of accounting policy changes relating to IFRS conversion on ICOFR and DC&P.	As the Company makes decisions on IFRS accounting policies and IFRS 1 choices, appropriate changes to ensure effective ICOFR and DC&P have been made.
Financial Statement Preparation	Identification of transactions impacted by IFRS conversion. An assessment of these transactions, appropriate changes and re-mapping of the financial statements and notes to the financial statements will be completed.	Changes and re-mapping of the financial statements and notes to the financial statements have commenced in fiscal 2011 and will continue for the 1 st quarter of fiscal 2012.
Financial Impact Analysis for Transactional Areas	Analysis of differences between Canadian GAAP and IFRS that was completed will be quantified by management. External auditors to review and sign-off on assessments.	Quantification of differences between Canadian GAAP and IFRS commenced during fiscal 2011. External auditor's review on assessments will be completed during fiscal 2012.
Business Activities Impact	Identification of impacts on business activities to be completed. For example, the review and assessment of contracts and agreements.	Assessments and identifications of impacts of the conversion to IFRS commenced during fiscal 2011. Identification of impacts is completed.

IFRS to Canadian GAAP Differences

The following is a summary of key IFRS to Canadian GAAP differences that may be applicable to the Company. It is not necessarily a complete list of all IFRS to Canadian GAAP differences that may have implications for the Company's financial reporting.

Share-based Payment Transactions

IFRS 2 Share-based Payment only requires recognition of equity instruments in respect of share-based payment transactions granted prior to the transition date. The Company expects to apply IFRS 2 to equity instruments granted after November 7, 2002 that have not vested by the transition date of July 1, 2010. The application of IFRS and Canada GAAP differs and the Company does not expect a significant difference.

Foreign Currency

IFRS requires an entity to assess its functional currency for each of its operations. Under Canadian GAAP all of the Company's operations were integrated; sharing the same functional currency. Under IFRS the Company's entities may have different functional currencies.

Financial Instruments

Under IFRS, an entity must assess its classification and measurement of financial instruments. The Company holds convertible debentures and warrants, for which the classification and measurement may change under IFRS.

Impairment of Assets

Canadian GAAP generally uses a two-step approach to impairment testing: first comparing asset carrying values with undiscounted future cash flows to determine whether impairment exists; and then measuring any impairment by comparing asset carrying values with fair values. IFRS uses a one-step approach for both testing for and measurement of impairment, with asset carrying values compared

directly with the higher of fair value less costs to sell and value in use (which uses discounted future cash flows). The difference in methodologies may result in asset impairments upon transition to IFRS.

Presentation and Note Disclosure

In accordance with IFRS, certain presentation and note disclosure will differ from Canadian GAAP. The Company will comply with all note disclosure and presentation requirements. As per IFRS 1, the Company will not use the benefit of hindsight in preparing its financial statements and note disclosure.

Provisions

IFRS Provisions, Contingent Liabilities, and Contingent Assets requires a provision to be recognized when: there is a present obligation as a result of a past transaction or event; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the obligation. "Probable" in this context means more likely than not. Under Canadian GAAP, the criterion for recognition in the financial statements is "likely," which is a higher threshold than "probable." Therefore, it is possible that some contingent liabilities would meet the recognition criteria under IFRS that were not recognized under Canadian GAAP.

Other differences between IFRS and Canadian GAAP exist in relation to the measurement of provisions, such as the methodology for determining the best estimate where there is a range of equally possible outcomes, and the requirement under IFRS for provisions to be discounted where material. This may give rise to a change in the measurement of the existing provisions and the identification of additional provisions.

First-Time Adoption of International Financial Reporting Standards

The Company's adoption of IFRS will require the application of IFRS 1 *First-Time Adoption of International Financial Reporting Standards*, which provides guidance for an entity's initial adoption of IFRS. IFRS 1 generally requires that an entity apply all IFRS effective at the end of its first IFRS reporting period retrospectively. However, IFRS 1 does include certain mandatory exceptions and limited optional exemptions in specified areas of certain standards from this general requirement.

Several IFRS Standards are in the process of being amended by the IASB. Amendments to existing standards are expected to continue up to and beyond the first IFRS reporting period of September 30, 2011. The Company is actively monitoring the IASB's schedule of projects, giving consideration to any proposed changes, where applicable, in its assessment of differences between IFRS and Canadian GAAP. In addition, new standards have been issued by the IASB that are not effective for the Company's first IFRS reporting year. The Company is not expected to early adopt any of these new IFRS Standards.

Part VIII: 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 risk 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 collection of accounts receivable could adversely affect the Company's liquidity. Management has implemented controls to ensure accounts receivable are current and suppliers payments are largely within terms. However, based on the current estimates, the Company cannot conclude that existing cash resources, together with cash expected to be generated by operations, will be sufficient to meet operating, capital and working capital requirements for at least the next twelve-month period.

Going Concern

There is significant doubt about the appropriateness of the going concern assumption because the Company reported a net loss of \$3.4 million for the year ended June 30, 2011 and a deficit of \$17.6 million as at June 30, 2011.

The Company's ability to continue as a going concern and to realize the carrying value of its assets and discharge its liabilities and commitments when due is dependent upon the Company's ability to restore profitable operations and raise additional capital.

No Record of Recent Profitability

The Company has incurred cumulative losses of \$15.8 million in the last four fiscal years, including \$3.4 million in 2011, \$3.0 million in 2010, \$9.2 million in 2009, and \$0.2 million in 2008 and there can be no assurance that the future business activities of the Company will restore profitability. The Company's ability to operate profitably and generate positive cash flow in the future will be affected by a variety of factors (including its ability to further develop and test its technology on schedule and on budget, the pace at which it secures additional customers, the time and expense required for the roll-out of its products, its success in marketing such product to its customers, the intensity of the competition experienced by the Company and the availability of additional capital to pursue its business plan, including development of new products). An inability to generate sufficient funds from operations will have a materially adverse effect on the Company's business, results of operations and financial condition.

Limited Managerial and Operating Resources

The Company's operations continue to generate a significant burden on the Company's limited management and operating resources, and may require that the Company hire additional employees and procure additional technical resources, as well as support and administrative personnel. There is no guarantee that the Company will be able to attract and keep the required personnel to meet its requirements or that it will be able to promptly satisfy customers' needs. The Company's business and operating results could be materially and unfavourably affected if it is not able to manage its limited resources.

Defaults under Credit Agreements

Credit facilities with the Canadian bank and the U.S. operating lender are demand facilities. In the event that the Company was in default under the terms of the agreements, the banks may thereafter demand repayment of all amounts owing under the bank indebtedness and by virtue of the inter-lender agreement, the Lender and the Debenture holder may also demand repayment.

For further discussion with respect to defaults under the Company's credit agreements, refer to the Bank Indebtedness, Long-term Debt and Convertible Debentures sections in Part IV of this MD&A.

Other Risks

Refer to the Company's June 30, 2011 consolidated financial statements note 15 for other risks including credit risk, interest risk, foreign exchange risk, liquidity risk, and fair value of financial instruments, and to the Joint Management Information Circular of PSP and Zuni dated November 24, 2010 for a discussion of other potential risks and uncertainties.

Part IX: OTHER INFORMATION

The authorized share capital of the Company consists of an unlimited number of common shares. As of October 24, 2011, there were 57,454,895 common shares outstanding. As of October 24, 2011, there were 4,875,000 options outstanding.

Consolidated Financial Statements of

PACIFIC SAFETY PRODUCTS INC.

Years ended June 30, 2011 and 2010



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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Pacific Safety Products Inc.

We have audited the accompanying consolidated financial statements of Pacific Safety Products Inc., which comprise the consolidated balance sheets as at June 30, 2011 and June 30, 2010, the consolidated statements of operations, comprehensive income and deficit and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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



Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Pacific Safety Products Inc. as at June 30, 2011 and June 30, 2010, and its consolidated results of operations and its consolidated cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 1 in the consolidated financial statements which indicates that Pacific Safety Products Inc. incurred a net loss of \$3,381,991 for the year then ended June 30, 2011 and has a deficit of \$17,556,357 as at June 30, 2011. These conditions, along with other matters as set forth in Note 1 in the consolidated financial statements, indicate the existence of a material uncertainty that may cast significant doubt about Pacific Safety Products Inc.'s ability to continue as a going concern.

KPMG LLP

Chartered Accountants, Licensed Public Accountants

October 24, 2011

Ottawa, Canada

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

AS AT JUNE 30

	2011	2010
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents (note 10)	\$ 2,897,735	\$ –
Accounts receivable	2,431,490	4,154,435
Inventory (note 5)	1,349,006	2,258,874
Prepaid expenses and deposits	279,560	204,677
Investment tax credits recoverable (note 6)	41,136	40,000
Assets held for sale (note 4)	–	250,215
Total current assets	6,998,927	6,908,201
PROPERTY AND EQUIPMENT (note 7)	1,095,910	1,426,667
PRODUCT DEVELOPMENT COSTS (note 8)	1,009,548	1,049,423
INTANGIBLE ASSETS (note 9)	1,222,113	2,756,327
TOTAL ASSETS	\$ 10,326,498	\$ 12,140,618
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Bank indebtedness (note 10)	\$ 693,026	\$ 2,410,390
Accounts payable and accrued liabilities	3,044,535	3,841,698
Deferred revenue	73,134	93,089
Income taxes payable	105,038	–
Current portion of long-term debt (note 11)	214,320	214,320
Total current liabilities	4,130,053	6,559,497
LONG-TERM DEBT (note 11)	839,420	946,580
CONVERTIBLE DEBENTURES (note 12)	728,653	–
TOTAL LIABILITIES	5,698,126	7,506,077
SHAREHOLDERS' EQUITY		
Share capital (note 13)	20,080,222	17,614,731
Warrants (note 13)	45,500	–
Contributed surplus (note 14)	1,768,027	1,194,176
Other paid-in capital (note 12)	290,980	–
Deficit	(17,556,357)	(14,174,366)
Total shareholders' equity	4,628,372	4,634,541
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 10,326,498	\$ 12,140,618

Going concern (note 1)
Commitments (note 20)
Subsequent events (notes 10, 12, 13, 20)

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

ON BEHALF OF THE BOARD OF DIRECTORS:



Douglas Lucky, Director



Daniel Marks, Executive Chairman of the Board

PACIFIC SAFETY PRODUCTS INC.
CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE INCOME AND DEFICIT

FOR THE YEARS ENDED JUNE 30

	2011	2010
SALES	\$ 22,663,696	\$ 29,989,255
COST OF SALES (note 5)	17,670,900	24,079,235
GROSS MARGIN	4,992,796	5,910,020
EXPENSES		
Sales and marketing	2,027,148	2,795,433
Research and development	315,396	225,694
General and administration	3,367,017	3,530,564
Foreign exchange losses	7,671	80,923
Amortization of property and equipment	154,089	205,929
Amortization of product development costs and intangible assets	607,085	531,531
Total expenses	6,478,406	7,370,074
LOSS BEFORE OTHER ITEMS	(1,485,610)	(1,460,054)
OTHER ITEMS		
Interest income	(26,808)	—
Interest on bank indebtedness	143,760	208,931
Interest on long-term debt	59,913	59,959
Interest on convertible debentures	87,169	—
Interest expense – accretion of convertible debentures (note 12)	88,525	—
Loss on sale of assets (note 4)	1,543,822	609,422
Write-down of investment tax credits recoverable (note 6)	—	589,926
Restructuring (note 19)	—	188,545
Total other items	1,896,381	1,656,783
LOSS BEFORE INCOME TAXES	(3,381,991)	(3,116,837)
INCOME TAXES		
Current income tax recovery	—	(21,283)
Future income tax recovery	—	(46,372)
Total income tax recovery (note 6)	—	(67,655)
NET AND COMPREHENSIVE LOSS	(3,381,991)	(3,049,182)
DEFICIT, BEGINNING	(14,174,366)	(11,125,184)
DEFICIT, ENDING	\$ (17,556,357)	\$ (14,174,366)
LOSS PER SHARE (note 17)		
BASIC AND DILUTED	\$ (0.083)	\$ (0.119)
WEIGHTED AVERAGE COMMON SHARES ISSUED AND OUTSTANDING (note 17)		
BASIC AND DILUTED	40,976,048	25,690,173

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

PACIFIC SAFETY PRODUCTS INC.
CONSOLIDATED STATEMENTS OF CASH FLOW

FOR THE YEARS ENDED JUNE 30

	2011	2010
OPERATING ACTIVITIES		
Cash receipts from customers	\$ 24,708,652	\$ 29,759,920
Cash paid to suppliers and employees	(25,514,929)	(28,080,334)
Interest paid	(203,673)	(268,890)
Interest received	26,808	-
Investment tax credits recovered	38,864	41,300
Income taxes paid	-	(20,550)
Other	5,144	-
CASH FLOW FROM (USED IN) OPERATING ACTIVITIES	(939,134)	1,431,446
INVESTING ACTIVITIES		
Purchase of property and equipment	(25,065)	(206,461)
Investment in new product development	(288,401)	(665,604)
Investment in intangible assets	(5,038)	(24,489)
Proceeds from sale of assets, net of selling costs	786,215	-
CASH FLOW FROM (USED IN) INVESTING ACTIVITIES	467,711	(896,554)
FINANCING ACTIVITIES		
Proceeds from issue of convertible debentures, net of issue costs	935,000	-
Repayment of long-term debt	(107,160)	(214,320)
Decrease in bank indebtedness	(1,717,364)	(555,268)
Restricted cash acquired pursuant to plan of arrangement (note 3)	2,649,699	-
Proceeds from the issue of equity instruments	-	14,714
Cash acquired pursuant to plan of arrangement (note 3)	1,892,642	-
Share issue costs (note 3)	(283,659)	-
CASH FLOW FROM (USED IN) FINANCING ACTIVITIES	3,369,158	(754,874)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,897,735	(219,982)
CASH AND CASH EQUIVALENTS, BEGINNING	-	219,982
CASH AND CASH EQUIVALENTS, ENDING	\$ 2,897,735	\$ -
Cash and cash equivalents consist of:		
Cash	\$ 797,735	\$ -
Guaranteed Investment Certificate	2,100,000	-
	\$ 2,897,735	\$ -

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

PACIFIC SAFETY PRODUCTS INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

Pacific Safety Products Inc. ("PSP" or the "Company"), incorporated under the Canada Business Corporations Act, manufactures and sells a complete line of protective products for the defence and security market. Nexus Armour Inc. ("Nexus") is a wholly-owned subsidiary of PSP and is the parent company of Sentry Armor Systems Inc. ("Sentry"). Sentry is incorporated in the State of Delaware, USA and commenced operations in Dover, Tennessee on July 5, 2006.

In accordance with the terms of a Plan of Arrangement, Zuni Holdings Inc. ("Zuni") became a wholly-owned subsidiary of PSP effective December 31, 2010. Zuni is the parent company of MTI Leewood GmbH and MTI Specialty Silicones Inc. Zuni and its subsidiaries have no operating business activities.

1. GOING CONCERN

These audited consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") on a going concern basis, which assumes that the future operations will allow for the realization of assets and discharge of liabilities and commitments in the normal course of business. Should the Company be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due. There is significant doubt about the appropriateness of the use of the going concern assumption because the Company incurred a net loss of \$3.4 million for the year ended June 30, 2011 and has a deficit of \$17.6 million as at June 30, 2011. In addition, as described below, the Company in certain prior periods had to seek waivers from its lenders related to debt to tangible net worth covenant violations on borrowings and entered into a forbearance agreement (the "Forbearance Agreement") with its Canadian bank (the "Bank").

The Company signed the Forbearance Agreement with the Bank on August 17, 2010. The Bank agreed, pursuant to the Forbearance Agreement, not to take steps to realize under the facility prior to February 28, 2011 (the "Forbearance Period") unless a terminating event as defined in the Forbearance Agreement occurs. The Bank extended the Forbearance Period until maturity of the facility on August 31, 2011. During the Forbearance Period, the Company was subject to, and in compliance with, amended financial covenants.

A condition of the Company's Forbearance Agreement with its Bank required the Company to request from the Lender a six-month postponement of principal payments related to its long-term debt. The Lender agreed to this request pursuant to a letter agreement dated August 4, 2010. All other terms and conditions of the debt facility remain unchanged (note 11).

On August 18, 2010, the Company issued a \$1 million unsecured convertible debenture in favour of a group of investors (note 12).

On December 31, 2010, the Company completed an amalgamation with Zuni by way of a Plan of Arrangement. The assets acquired included unrestricted cash of \$1.9 million (note 3). Restricted cash of \$2.6 million being held in escrow was released prior to June 30, 2011.

On August 31, 2011, the Company entered into a Loan Agreement ("Agreement") with another Canadian bank to become PSP's principal Canadian lender and to provide a \$1.0 million credit facility that is secured by cash collateral of \$1.0 million (note 10). The Agreement replaces the Company's previous principal Canadian operating lender.

The Company's ability to continue as a going concern and to realize the carrying value of its assets and discharge its liabilities when due is dependent upon the Company's ability to restore profitable operations and raise additional capital. These consolidated financial statements do not include any adjustments to the carrying value and classification of assets and liabilities that would be necessary should the Company be unable to continue as a going concern, and such adjustments could be material.

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 include the accounts of Pacific Safety Products Inc. and its wholly-owned subsidiaries, Nexus, Sentry and Zuni. All intercompany transactions and balances are eliminated on consolidation.

Cash and Cash Equivalents

Cash and cash equivalents consist of unrestricted cash in bank accounts and includes short-term investments that are redeemable.

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Inventory

Raw materials are measured at the lower of weighted average cost and net realizable value. Work-in-process and finished goods and samples are measured at the lower of average cost, which includes direct manufacturing expenses and an allocation of overhead, and net realizable value.

Property and Equipment

Property and equipment is recorded at cost. Amortization of property and equipment is calculated using the following methods and annual rates:

Office equipment	20% diminishing balance
Manufacturing equipment	20% diminishing balance
Computer equipment	30% diminishing balance
Test and design equipment	30% diminishing balance
Leasehold improvements	straight-line over five years or the term of the lease

Product Development Costs

Research and development costs include out-of-pocket cost and direct overhead. Research costs are expensed as incurred and are reduced by related government assistance and tax incentives. Product development costs are expensed as incurred unless they meet Canadian generally accepted accounting criteria for deferral and amortization. Amortization for product development costs commences in the year that the new product development is completed and commercial production commences. These costs are amortized using the straight-line method over five years.

Intangible Assets

Patents and trademarks are recorded at cost. Customer relationships, tradenames and non-compete agreements are recorded at cost which, for business acquisitions, represents the estimated fair market value at the date of the acquisition. Amortization of intangibles is calculated using the following methods and annual rates which are intended to reflect the assets' estimated useful life:

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

Impairment of Long-lived Assets

Long-lived assets, including property and equipment, product development costs and intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability is measured by a comparison of the carrying amount to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset exceeds its estimated future cash flows, an impairment charge is recognized as the amount by which the carrying value of the asset exceeds the fair value of the asset. Assets to be disposed of are separately presented in the balance sheet and are reported at the lower of the carrying amount or fair value less costs to sell, and are no longer amortized.

Revenue Recognition

Revenue is recognized when there is evidence of arrangement, the amount is fixed or determinable, products are shipped to the customer, and collection is reasonably assured and is recorded net of discounts. Amounts received prior to the shipment of products are recognized as deferred revenue in the period received and recorded as revenue when the products are shipped.

Income Taxes

Income taxes are determined using the asset and liability method whereby future income tax assets and liabilities are recognized for the future income tax consequences attributable to temporary differences between the financial reporting basis and the income tax basis of assets and liabilities and operating loss carryforwards based on enacted income tax rates expected to apply in the periods in which the temporary differences are expected to be realized or settled.

Government Assistance

Government assistance related to capital expenditures is reflected as a reduction in the cost of such assets. Government assistance relating to research and development expenses is recorded as a reduction of expenses when the related expenditures are incurred and recovery is reasonably certain. When government assistance is received which relates to expenses of future periods, the amount is deferred and amortized to income as the related expenditures are incurred.

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Loss Per Share

Basic loss per share is calculated by dividing the loss for the period by the weighted average number of common shares outstanding during the period. The Company uses the treasury stock method for calculating the dilutive effect of the outstanding stock options and warrants. Under the treasury stock method, the weighted average number of common shares outstanding used for the calculation of diluted loss per share assumes that the proceeds to be received on the exercise of dilutive share options are used to repurchase common shares at the average market price during the period. The Company uses the "if-converted" method for calculating the dilutive effect of other convertible securities.

Foreign Currency Translation

The measurement currency of the Company and its subsidiaries is the Canadian dollar. Integrated foreign operations and foreign denominated assets and liabilities of the Company are translated using the temporal method. Under this method, monetary assets and liabilities denominated in foreign currencies are translated at the exchange rates in effect at the balance sheet date. Non-monetary assets are translated at the historical rate of exchange. Revenue and expenses are translated at the rates of exchange prevailing on the transaction date. Gains and losses on translation are reflected in the consolidated statement of operations, comprehensive income and deficit.

Financial Instruments

The Company classifies financial assets and liabilities according to their characteristics and management's choices and intentions related thereto for the purposes of ongoing measurements. Classification choices for financial assets include: a) held for trading - measured at fair value with changes in fair value recorded in net operations; b) held to maturity - measured initially at fair value and carried at amortized cost with gains and losses recognized in net operations in the period that the asset is derecognized or impaired; c) available for sale - measured at fair value with changes in fair value recognized in other comprehensive loss for the current period until realized through disposal or impairment; and d) loans and receivables - measured initially at fair value and carried at amortized cost with gains and losses recognized in operations in the period that the asset is no longer recognized or impaired. Classification choices for financial liabilities include: a) held for trading - measured at fair value with changes in fair value recorded in operations and b) other - measured initially at fair value and carried at amortized cost. Any financial asset or liability can be classified as held for trading as long as its fair value is reliably determinable.

The Company's financial assets and liabilities are classified and measured as follows:

Asset/Liability	Classification	Measurement
Cash and cash equivalents	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Bank indebtedness	Other liabilities	Amortized cost
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost
Convertible debentures	Other liabilities	Amortized cost

Transaction costs other than those related to financial instruments classified as held for trading and issuance of convertible debentures, which are expensed as incurred, are added to the fair value of the financial asset or financial liability on initial recognition and amortized using the effective interest method.

Cash Flow

The Company uses the direct method of reporting cash flow from operating activities.

Measurement Uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from these estimates.

The amounts accrued to recognize investment tax credits (excluding investment tax credits recoverable) and future income tax assets are based on the Company's estimate of the likelihood that it will have sufficient future taxable income to realize these assets. Significant management estimates are found in the impairment analysis and useful lives of intangible assets, property and equipment and product development costs.

By their nature, these estimates are subject to measurement uncertainty and the effects of changes in estimates and judgments will be recorded in the period such changes are made.

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

Stock-Based Compensation

The Company has a stock option plan which is described in note 13. The Company accounts for stock options granted to employees and directors using the fair value method. Under this method, compensation expense for stock options granted is measured at the fair value at the grant date, using the Black-Scholes option valuation model. In accordance with the fair value method, the Company recognizes estimated compensation expense related to stock options over the vesting period of the options granted, with the related credit being charged to contributed surplus.

3. PLAN OF ARRANGEMENT

Pursuant to a Plan of Arrangement effective December 31, 2010, the Company acquired all of the outstanding common shares of Zuni in exchange for PSP common shares at an agreed exchange ratio of one PSP common share for each Zuni common share. Zuni was amalgamated with a wholly-owned subsidiary of PSP incorporated for the purpose of carrying out the Plan of Arrangement. The amalgamated entity was continued as Zuni Holdings Inc., a subsidiary of PSP.

This transaction has been accounted for as the acquisition of the assets and liabilities of Zuni in exchange for PSP common shares valued at the date of completion of the acquisition. The number of PSP common shares issued was 30,468,334 and the PSP share price was \$0.09 resulting in purchase consideration of \$2,742,150 related to the shares issued (note 13).

The Company also issued 2,000,000 replacement stock options and recorded the fair value of the options of \$106,400 in purchase consideration (note 14). In accordance with the terms of the Plan of Arrangement, 2,000,000 Zuni stock options outstanding immediately prior to the transaction were exchanged for PSP replacement stock options at an exercise price of \$0.10. The PSP replacement stock options were fair-valued using the Black-Scholes option pricing model at the effective date of the transaction using the following assumptions:

Remaining life	4.6 years
Volatility	77%
Dividends	—
Risk-free interest rate	2.4%

A summary of net assets acquired is as follows:

Assets acquired:	
Cash	\$ 1,892,642
Restricted cash	2,649,699
Accounts receivable and prepaid expenses	372,446
Asset held for sale	184,124
	<u>5,098,911</u>
Liabilities assumed:	
Accounts payable and accrued liabilities	(1,789,243)
Income taxes payable	(99,893)
	<u>(1,889,136)</u>
Excess value of net assets acquired over consideration paid (note 14)	(361,225)
Total purchase consideration	<u>\$ 2,848,550</u>

All costs incurred by the Company relating to the Plan of Arrangement have been recorded as share issue costs and presented as a reduction in share capital.

A summary of the restricted cash acquired is as follows:

Cash in escrow, released June 11, 2011	\$ 2,550,240
Cash in escrow, released March 30, 2011	99,459
	<u>\$ 2,649,699</u>

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4. ASSETS HELD FOR SALE

On August 18, 2010, the Company sold certain PSP headborne system assets, in particular, the helmet liner capability, for \$275,000 and a 4% royalty on gross sales over a five-year period. On September 14, 2010, the purchaser exercised an option to acquire the remainder of the headborne systems for an additional \$100,000 and a 2.5% royalty on gross sales over a five-year period. The Company recorded a loss of \$609,422 related to this transaction in the year ended June 30, 2010 based on the fair value of the assets, less estimated costs to complete the sale. The Company recorded a further loss of \$39,838 related to this transaction in the year ended June 30, 2011.

On December 31, 2010, by virtue of the Plan of Arrangement, the Company acquired land and building that was held for sale in the amount of \$184,124 (note 3). The sale of this asset was completed on January 19, 2011 and net proceeds received were US\$187,376 (\$185,086).

On May 5, 2011, the Company completed the sale of certain assets of APS Distributors, a division of PSP located in Bedford, Nova Scotia, with a carrying value of \$1,913,698, for a purchase price of \$500,000 before transaction costs of \$90,286. The Company recorded a loss on the sale of \$1,503,984. Proceeds from the sale, net of an \$18,000 holdback, have been used to reduce debt obligations.

5. INVENTORY

	2011	2010
Raw materials	\$ 2,031,037	\$ 1,885,897
Work-in-process	101,553	13,507
Finished goods and samples	7,115	1,119,254
	2,139,705	3,018,658
Less provision	(790,699)	(759,784)
	\$ 1,349,006	\$ 2,258,874

Write-down of inventories recognized as an expense and recorded in cost of sales during the year ended June 30, 2011 was \$180,756 (June 30, 2010 - \$1,079,308).

The following table sets forth details of cost of sales:

	2011	2010
Inventory expensed	\$ 11,773,138	\$ 17,584,421
Labour costs	2,880,227	3,182,252
Other costs	3,017,535	3,312,562
	\$ 17,670,900	\$ 24,079,235

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6. INCOME TAXES

	2011	2010
Future tax asset:		
Loss carryforwards	\$ 5,076,317	\$ 1,967,836
Financing costs	435,751	6,352
Reserves	483,211	292,797
Harmonization tax credit	11,542	10,818
Scientific research and development	86,958	12,928
Intangibles and other assets	957,872	905,823
Total gross future tax asset	7,051,651	3,196,554
Less valuation allowance	(6,859,409)	(3,023,915)
Net future tax asset	192,242	172,639
Future tax liability:		
Property and equipment	(181,752)	(161,773)
Investment tax credits	(10,490)	(10,866)
Net future tax asset / (liability)	\$ -	\$ -

Loss carryforwards at June 30, 2011 include those of Zuni and its subsidiaries against which there is a full valuation allowance.

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

For the years ended June 30	2011	2010
Statutory income tax rate	29.5%	32%
Expected Canadian income tax recovery	\$ (998,533)	\$ (996,453)
(Increase) decrease resulting from:		
Change in valuation allowance	590,884	734,259
Change in foreign exchange rate	105,600	144,602
Change in Canadian statutory rate	180,858	86,975
Difference between Canadian and U.S. statutory income tax rates	(13,331)	(50,821)
Income tax effect of items not deductible for income tax purposes	173,401	7,638
Income tax effect of items not taxable for income tax purposes	93,806	(151,348)
Adjustment for prior years income tax matters	(125,146)	146,437
Other	(7,539)	11,056
Income tax expense (recovery)	\$ -	\$ (67,655)

At June 30, 2011, the Company had approximately \$4.3 million in Canadian tax non-capital loss carryforwards and \$2.9 million of U.S. net operating loss carryforwards available, excluding loss carryforwards of Zuni and its subsidiaries which have no operating business activities. The unused losses will expire between 2026 and 2031.

As at June 30, 2010, management determined that there was no reasonable assurance that its non-refundable investment tax credits could be utilized. As a result, the Company wrote down these investment tax credits by \$0.6 million. Therefore, together with non-refundable tax credits expected to be filed for the current year, the Company has \$0.6 million of non-refundable investment tax credits for tax purposes, which expire between 2025 and 2030.

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7. PROPERTY AND EQUIPMENT

	2011			2010		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Office equipment	\$ 216,267	\$ 165,613	\$ 50,654	\$ 321,027	\$ 187,406	\$ 133,621
Manufacturing equipment	2,458,559	1,732,651	725,908	2,406,403	1,559,949	846,454
Computer equipment	1,243,744	1,046,828	196,916	1,307,045	1,048,520	258,525
Test and design equipment	86,757	84,014	2,743	86,757	82,838	3,919
Leasehold improvements	270,730	151,041	119,689	308,059	123,911	184,148
	\$ 4,276,057	\$ 3,180,147	\$ 1,095,910	\$ 4,429,291	\$ 3,002,624	\$ 1,426,667

Of the total amortization expense of \$335,469 for the year ended June 30, 2011 (June 30, 2010 - \$439,601) there is \$181,380 (June 30, 2010 - \$233,672) recorded in cost of sales.

8. PRODUCT DEVELOPMENT COSTS

	2011			2010		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Product development costs	\$ 1,930,141	\$ 920,593	\$ 1,009,548	\$ 1,668,232	\$ 618,809	\$ 1,049,423

9. INTANGIBLE ASSETS

	2011			2010		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Patents	\$ 95,093	71,156	\$ 23,937	\$ 92,242	\$ 60,722	\$ 31,520
Trademarks	48,911	40,347	8,564	46,724	36,731	9,993
Customer relationships	1,403,658	612,869	790,789	3,179,128	899,839	2,279,289
Non-compete agreements	171,273	170,327	946	171,273	170,327	946
Tradenames	550,531	152,654	397,877	550,531	115,952	434,579
	\$ 2,269,466	\$ 1,047,353	\$ 1,222,113	\$ 4,039,898	\$ 1,283,571	\$ 2,756,327

Intangible assets with a net book value of \$1,260,512 were disposed of in conjunction with the sale of certain assets of the APS Distributors division (note 4).

10. BANK INDEBTEDNESS

PSP had an agreement with the Bank to provide advances repayable on demand with interest payable monthly calculated at the bank prime lending rate plus 3.50% per annum. The loan was secured by a first priority general security agreement over Canadian accounts receivable and inventory. The maximum operating line was \$3.0 million, reduced to \$1.0 million following the sale of the APS Distributors division and the release of cash being held in escrow, and was subject to margin requirements and covenants set by the Bank. At June 30, 2011, the amount drawn on the line of credit was \$693,026 (June 30, 2010 - \$1,875,094). The Company signed the Forbearance Agreement with the Bank on August 17, 2010 and the Bank extended the Forbearance Period through to the maturity of the facility on August 31, 2011.

PSP signed an Agreement with another Canadian bank on August 31, 2011 for a replacement credit facility in the amount of \$1.0 million. The new facility is a revolving demand facility available by way of overdraft with interest payable monthly calculated at the bank prime lending rate plus 1.95% per annum. The facility is secured by cash collateral of \$1.0 million and a general security agreement over all personal property of PSP and its subsidiaries. The Agreement has no financial covenants and is subject to certain general covenants as outlined in the Agreement.

Sentry has an agreement with a United States bank to provide advances repayable on demand with interest payable monthly calculated at the bank prime lending rate plus 2.00% per annum. The loan is secured by a first priority general security agreement over U.S. accounts receivable, inventory and an assignment of insurance. The maximum operating line is \$1.4 million USD and is subject to margin requirements and covenants set by the lenders. At June 30, 2011, the amount drawn on the line of credit was \$Nil (June 30, 2010 - \$535,296).

11. LONG-TERM DEBT

	2011	2010
Secured term loan with interest payable monthly calculated at the Lender's floating base rate of 5% at June 30, 2011 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 May 23, 2016.		
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 bank providing a Canadian credit facility.		
A condition of the Company's Forbearance Agreement with its Canadian bank required the Company to request from its Lender a six-month postponement of principal payments related to its long-term debt. The Lender agreed to this request pursuant to a letter agreement dated August 4, 2010. All other terms and conditions of the debt facility remain unchanged. Principal payments resumed on February 23, 2011.	\$ 1,053,740	\$ 1,160,900
Less current portion	(214,320)	(214,320)
	\$ 839,420	\$ 946,580

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

2012	\$ 214,320
2013	214,320
2014	214,320
2015	214,320
2016	196,460
	\$ 1,053,740

12. CONVERTIBLE DEBENTURES

On August 17, 2010, the Company completed a private placement of \$1,000,000 aggregate principal amount, consisting of 40 units (the "Units") at a purchase price of \$25,000 per Unit. Each Unit consists of \$25,000 in principal amount of unsecured convertible debentures (the "Debentures") and 62,500 detachable common share purchase warrants (the "Warrants").

The Debentures mature three years from the date of issuance and bear interest at a rate of 10% per annum, payable annually in cash or common shares at the option of the Company. The Company elected to settle interest payable on convertible debentures as of August 17, 2011 in the amount of \$100,000 with the issuance of 1,145,408 common shares. The holder has the right to convert all (but not less than all) principal and accrued interest at any time to common shares at a rate of one common share per \$0.10 of indebtedness (the "Conversion Option").

The Warrants have a one-year term with an exercise price of \$0.10 per common share during the first six-months and an exercise price of \$0.12 per common share during the second six-months of the term. The Warrants expired unexercised on August 17, 2011.

On the date of issuance, the gross proceeds in the amount of \$1,000,000 have been allocated based on the relative fair values of the Debentures (\$640,128), the Conversion Option (\$314,372) and the Warrants (\$45,500). The relative fair value of the Debentures is classified as a liability, while the relative fair values of the Conversion Option and Warrants have been classified as separate components of shareholders' equity.

Over the three-year term, the Debentures are accreted to their principal amount through a periodic charge to accretion expense with a corresponding credit to the liability component. The accretion expense is based on the effective interest method. For the year ended June 30, 2011, the Company recorded accretion expense of \$88,525 related to the Debentures.

The Company incurred transaction costs of \$65,000 in connection with the issuance of the Debentures. These costs were allocated to Debenture issuance costs (\$41,608) and to equity issuance costs (\$23,392) based on the relative fair values of the debt and equity components. The Company has elected a policy to expense Debenture transaction costs as incurred.

The fair value of the Conversion Option was estimated using the Black-Scholes option pricing model assuming no expected dividends, a volatility of the Company's share price of 89%, a risk-free interest rate of 1.75%, and an expected life of three years.

The fair value of the Warrants was estimated using the Black-Scholes option pricing model assuming no expected dividends, a volatility of the Company's share price of 101%, a risk-free interest rate of 1.4%, and an expected life of one year.

The fair value of the Debentures was estimated using the present value of future cash flows using a discount rate of 18%.

Certain Directors of the Company beneficially own or control, directly or indirectly, \$750,000 aggregate principal amount of the Debentures and 1,875,000 Warrants.

The Debentures contain certain default provisions that would provide the holders the right to demand repayment. The Company was in compliance with these conditions at June 30, 2011.

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13. EQUITY INSTRUMENTS

(a) Authorized and issued

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

	2011		2010	
	Number of Shares	Amount	Number of Shares	Amount
Beginning balance	25,741,153	\$ 17,614,731	25,654,605	\$ 17,600,017
Employee Share Ownership Plan	–	–	86,548	14,714
Shares issued under the Plan of Arrangement (note 3)	30,468,334	2,742,150	–	–
Share issue costs (note 3)	–	(283,659)	–	–
Restricted shares (note 13(c))	100,000	7,000	–	–
Balance, June 30	56,309,487	\$ 20,080,222	25,741,153	\$ 17,614,731

On August 17, 2011, the Company issued 1,145,408 common shares at a deemed price of \$0.087305 per share in settlement of interest payable on the Debentures.

(b) Warrants

	2011		2010	
	Number of Warrants	Amount	Number of Warrants	Amount
Private placement – August 17, 2010 (note 12)	2,500,000	\$ 45,500	–	\$ –
Balance, end of year	2,500,000	\$ 45,500	–	\$ –

The Warrants expired unexercised on August 17, 2011.

(c) 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 62,206 and 100,000 Restricted Shares on November 26, 2007 and November 26, 2008, respectively, and issued the shares on June 16, 2009. The Company granted 100,000 Restricted Shares on November 29, 2010 and issued the shares on January 27, 2011.

(d) Stock Options

The Company had 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, subject to certain exceptions whereby specific board members' options expire one year after 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.

On December 22, 2010, the Board approved the New PSP Stock Option Plan. Under the New PSP Stock Option Plan, the PSP Board determines the term of any options granted, which shall not exceed ten years from the date of grant. The exercise price and vesting periods will be determined by the Board of Directors upon issuance. The expiration of any PSP option will be accelerated if the participant's employment or other relationship with PSP terminates. Vested options may be exercised until the earlier of the fixed expiry date or a period of up to one year following the date the optionee ceases to be a participant as determined by the PSP Board at the time of the option grant.

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13. EQUITY INSTRUMENTS (continued)

(d) Stock Options (continued)

The aggregate number of PSP shares that may be reserved for issuance pursuant to PSP options shall not exceed 10% of the outstanding PSP shares at the time of granting of a PSP option, less the aggregate number of shares reserved for issuance under any other PSP share compensation arrangement.

At June 30, 2011, the Company had 4,884,000 stock options outstanding with exercise prices ranging from \$0.10 to \$0.87.

	<i>Total</i>		<i>Weighted Average Exercise Price</i>
Balance June 30, 2009	847,800	\$	0.70
Granted	155,000		0.14
Expired	(15,000)		1.95
Balance, June 30, 2010	987,800	\$	0.59
Expired	(978,800)		0.58
Issued pursuant to Plan of Arrangement (note 3)	2,000,000		0.10
Granted	2,875,000		0.10
Balance, June 30, 2011	4,884,000	\$	0.10
Total Stock Option Pool Authorized			5,630,948
Total Stock Option Pool Remaining			746,948

The fair value of stock options issued in fiscal 2010 was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility range from 0.71 to 0.73, risk-free interest rate of 4%, and expected option life of five years with a fair value ranging from \$0.11 to \$0.14. 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 0.69 to 0.93, risk-free interest rate of 2%, and expected option life of two to five years with a fair value ranging from \$0.05 to \$0.06.

The following table summarizes information regarding the Company's outstanding stock options at June 30, 2011:

<i>Options Outstanding</i>			<i>Options Exercisable</i>		
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$0.10	4,875,000	4.48	\$ 0.10	3,458,333	\$ 0.10
\$0.68 to \$0.87	9,000	0.19	0.79	9,000	0.79
	4,884,000		\$ 0.10	3,467,333	\$ 0.10

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14. CONTRIBUTED SURPLUS

	2011	2010
Balance, beginning of year	\$ 1,194,176	\$ 1,176,991
Stock-based compensation	113,226	17,185
Fair value of options issued (note 3)	106,400	-
Excess value of net assets acquired over consideration paid (note 3)	361,225	-
Release to share capital on reclassification of restricted shares	(7,000)	-
Balance, end of year	\$ 1,768,027	\$ 1,194,176

15. FINANCIAL RISK MANAGEMENT

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.

(a) 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 June 30, 2011, the Company had \$0.5 million (June 30, 2010 - \$1.3 million) in accounts receivable with the Canadian Federal Government.

In monitoring credit risk, the Company considers industry, sales 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 management. The Company maintains reserves for potential credit losses relating to specific exposures.

The maximum exposure to credit risk is the carrying value of accounts receivable.

The movement in the allowance for doubtful accounts receivable in respect of trade accounts receivable during the year reflects the write-off of amounts previously provided for.

The following table sets forth details of accounts receivable:

	2011	2010
Not past due	\$ 1,792,373	\$ 3,006,823
Past due for more than one day but not more than 30 days	489,801	556,426
Past due for more than 31 days but not more than 60 days	84,092	292,798
Past due for more than 61 days	83,989	359,326
	2,450,255	4,215,373
Less: allowance for doubtful accounts	(18,765)	(60,938)
	\$ 2,431,490	\$ 4,154,435

As at June 30, 2011, the Company's accounts receivable consist of balances due from customers in different jurisdictions including Canada amounting to \$1,193,460 (June 30, 2010 - \$2,981,805), the United States amounting to \$1,190,517 (June 30, 2010 - \$1,172,630), and other countries amounting to \$47,513 (June 30, 2010 - \$Nil).

(b) Interest Rate Risk

The Company is exposed to interest rate risk with regard to short-term variable rate credit facilities and a long-term variable rate secured loan. For the year ended June 30, 2011, if interest rates on the operating lines and long-term debt were to fluctuate by 1%, and all other variables were held constant, the impact on the Company's operations before income taxes would be \$27,244.

15. FINANCIAL RISK MANAGEMENT (continued)

(c) Foreign Exchange Risk

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

A significant portion of the Company's raw material used in production and products purchased for resale are denominated in U.S. dollars. Therefore, a decrease in the value of the Canadian dollar relative to the U.S. dollar increases the Company's costs, which reduces operating margin and the cash flow available to fund operations. The Company also has an investment in a U.S. integrated operation.

For the year ended June 30, 2011, if the rate of exchange between the U.S. and Canadian dollar were to fluctuate by 10%, and all other variables were held constant, the impact on the Company's operations before income taxes would be \$266,033.

(d) 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 credit facilities available and monitoring cash requirements to meet expected operational expenses including debt service and capital requirements.

The Company has a \$1.0 million credit facility with a Canadian chartered bank and \$1.4 million USD operating line of credit with a U.S. chartered bank (note 10).

The following table summarizes the carrying amount and contractual maturities of significant financial liabilities over the next 5 years, on an undiscounted basis as at June 30, 2011.

	2012	2013	2014	2015	2016	Total
Accounts payable and accrued liabilities	\$ 3,044,535	\$ -	\$ -	\$ -	\$ -	\$ 3,044,535
Operating leases	545,037	596,489	518,247	464,911	464,911	2,589,595
Bank indebtedness	693,026	-	-	-	-	693,026
Long-term debt	269,262	256,938	244,615	232,292	202,108	1,205,215
Convertible debentures	-	-	1,000,000	-	-	1,000,000

(e) Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, bank indebtedness, accounts payable and accrued liabilities, convertible debentures and long-term debt. The fair values of accounts receivable, bank indebtedness, and 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 debt reflects current market interest rates and therefore the carrying amount approximates fair value. Convertible debentures were measured initially at fair value and are carried at amortized cost. The fair value of the Debentures was estimated to be \$953,373 at June 30, 2011 using the present value of future cash flows and a discount rate of 18%.

Financial instruments recorded at fair value on the consolidated balance sheet are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

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

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

There are no financial instruments measured at fair value other than cash and cash equivalents which is classified as Level 1. During the year, there have been no transfers of amounts between any categories. There are no items classified as Level 2 or Level 3 as at June 30, 2011.

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16. CAPITAL DISCLOSURES

The Company's objectives when managing capital are: i) to ensure sufficient liquidity to support its financial obligations and execute its operating and strategic plans, ii) to minimize the cost of capital while taking into consideration current and future industry, market and economic risks and conditions, and iii) to maintain an optimal capital structure that provides necessary financial flexibility while also ensuring compliance with financial covenants.

The Company monitors its capital structure, when necessary, in light of changes in economic conditions, the objectives of its shareholders, the cash requirements of the business and the condition of capital markets.

The Company considers its total capitalization to include all interest-bearing debt, including bank indebtedness, long-term debt (including the current portion thereof), convertible debentures and shareholders' equity, net of cash. The calculation is set out in the following table:

	2011	2010
Bank indebtedness	\$ 693,026	\$ 2,410,390
Current portion of long-term debt	214,320	214,320
Long-term debt	839,420	946,580
Convertible debentures	728,653	-
Debt	2,475,419	3,571,290
Shareholders' equity	4,628,372	4,634,541
Cash and cash equivalents	(2,897,735)	-
Capital under management	\$ 4,206,056	\$ 8,205,831

There have been no changes in the Company's approach to capital management during fiscal 2011.

17. LOSS PER SHARE

As the Company incurred a net loss during the years ended June 30, 2011 and 2010, the loss and diluted loss per common share are based on the weighted-average common shares outstanding during the period. The following outstanding instruments could have a dilutive effect in the future:

	2011	2010
Shares issuable on conversion of convertible debentures	10,000,000	-
Stock options	4,884,000	987,800
	14,884,000	987,800

PACIFIC SAFETY PRODUCTS INC.
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18. SEGMENTED INFORMATION

The Company's principal business activity is the manufacture, distribution and sale of a complete line of protective products and accessories for the defence and security market. The Company operates in Canada through its PSP and formerly APS Distributors (note 4) divisions with operations based in Arnprior, Ontario and formerly Bedford, Nova Scotia respectively, and in the U.S. through its Sentry subsidiary located in Dover, Tennessee. Head office expenses, including the office of the CEO and public company costs, are reported as Corporate.

These segments represent the Company's reportable segments, which are used to manage the business. The Company analyzes the performance of its operating segments based on revenue growth and operating profitability. Assets acquired pursuant to the Plan of Arrangement (note 3) are reported as Corporate assets.

	Canadian Operations	U.S. Operations	Corporate	Consolidated Total
<i>For the year ended June 30, 2011</i>				
Revenue	\$ 13,505,435	\$ 9,258,220	\$ –	\$ 22,763,655
Elimination of inter-segment revenue	(45,473)	(54,486)	–	(99,959)
Total revenue	13,459,962	9,203,734	–	22,663,696
Gross margin	3,121,874	1,870,922	–	4,992,796
Expenses	2,379,859	1,778,309	1,559,064	5,717,232
Amortization	564,140	197,034	–	761,174
Other items	1,873,076	50,113	(26,808)	1,896,381
Income tax expense (recovery)	–	–	–	–
Net loss after taxes	\$ (1,695,201)	\$ (154,534)	\$ (1,532,256)	\$ (3,381,991)
<i>For the year ended June 30, 2010</i>				
Revenue	\$ 21,260,061	\$ 9,480,501	\$ –	\$ 30,740,562
Elimination of inter-segment revenue	(27,034)	(724,273)	–	(751,307)
Total revenue	21,233,027	8,756,228	–	29,989,255
Gross margin	4,490,450	1,419,570	–	5,910,020
Expenses	3,076,300	1,933,332	1,622,982	6,632,614
Amortization	482,810	254,650	–	737,460
Other items	1,626,773	30,010	–	1,656,783
Income tax expense (recovery)	(88,205)	20,550	–	(67,655)
Net loss after taxes	\$ (607,228)	\$ (818,972)	\$ (1,622,982)	\$ (3,049,182)

PACIFIC SAFETY PRODUCTS INC.
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18. SEGMENTED INFORMATION (continued)

	Canadian Operations	U.S. Operations	Corporate	Consolidated Total
AS AT JUNE 30, 2011				
Assets				
Current assets	\$ 2,209,130	\$ 1,780,366	\$ 3,009,431	\$ 6,998,927
Property and equipment	666,790	429,120	–	1,095,910
Intangible assets and product development costs	1,042,049	1,189,612	–	2,231,661
	\$ 3,917,969	\$ 3,399,098	\$ 3,009,431	\$ 10,326,498

AS AT JUNE 30, 2010

Assets				
Current assets	\$ 5,309,408	\$ 1,598,793	\$ –	\$ 6,908,201
Property and equipment	880,079	546,588	–	1,426,667
Intangible assets and product development costs	2,442,789	1,362,961	–	3,805,750
	\$ 8,632,276	\$ 3,508,342	\$ –	\$ 12,140,618

Revenue for the year ended June 30	2011	2010
Domestic	\$ 13,363,213	\$ 19,967,849
United States	8,976,083	8,212,331
International	324,400	1,809,075
	\$ 22,663,696	\$ 29,989,255

Included in Fiscal 2011 revenue were sales of \$5.0 million to the Canadian Federal Government (Fiscal 2010 - \$6.7 million) which represents 22.1% (Fiscal 2010 - 22.5%) of total sales. Sales to one US customer were \$2.9 million (Fiscal 2010 - \$0.4 million) which represents 13.0% (Fiscal 2010 - 1.2%) of total sales. 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.

19. RESTRUCTURING

	2011	2010
Opening balance	\$ 102,690	\$ 19,843
Restructuring costs incurred	–	188,545
Restructuring costs paid	(86,311)	(105,698)
	\$ 16,379	\$ 102,690

During the year ended June 30, 2010, the Company implemented a restructuring plan directed at reducing costs.

PACIFIC SAFETY PRODUCTS INC.
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20. COMMITMENTS

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

2012	\$	545,037
2013		596,489
2014		518,247
2015		464,911
2016		464,911
Thereafter		426,169
		<hr/>
		\$ 3,015,764

On August 16, 2011, the Company signed a sublease for the remaining lease term for its former head office premises in Kanata, Ontario. As a result of entering in this sublease, future operating lease commitments included in the table above will be reduced by \$438,000 during the period from September 2011 to May 2017.

21. RELATED PARTY TRANSACTIONS

Consulting expenses for services performed by a shareholder and director of the Company during fiscal 2011 were \$60,000 (fiscal 2010 - \$Nil). These expenses are included in general and administrative expenses.

22. COMPARATIVE FIGURES

In certain instances the information presented for comparative purposes have been reclassified to conform to the financial statement presentation adopted for the current year.