



PACIFIC SAFETY PRODUCTS INC.

REPORT TO SHAREHOLDERS

**MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE
SIX MONTHS ENDED DECEMBER 31, 2010 AND 2009**

Management's Discussion and Analysis

December 31, 2010 and 2009

(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 February 28, 2011 and should be read together with the Company's unaudited interim consolidated financial statements for the six months ended December 31, 2010, the audited annual consolidated financial statements and the notes thereto for the year ended June 30, 2010, 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, 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 and the existence of defaults under such covenants, the inability to reach agreement with the Bank regarding the normalization of the Company's credit facility, the potential impact of the recent 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 VII: 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 February 28, 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 information 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 Strategy
- II. Results
- III. Cash Flow
- IV. Liquidity and Capital Resources
- V. Quarterly Results
- VI. Critical Accounting Estimates, Changes to Accounting Policies
- VII. Risks and Uncertainties
- VIII. Other Information

Part I: BUSINESS OVERVIEW AND STRATEGY

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 also provides specialized law enforcement and safety products through APS Distributors ("APS"), a division of PSP that services law enforcement and public safety agencies across Canada. The Company, through its wholly-owned subsidiary, Sentry Armor Systems Inc. ("Sentry"), provides body armour products to U.S.-based law enforcement and private security firms. The Company's business strategy is to maintain its core body armour market while growing its portfolio of products so that more of what a customer wears or carries to the front line is sold by PSP.

PSP has a significant recurring revenue stream from its Canadian customers in the form of 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, a distribution centre in Bedford, Nova Scotia and its head office is located in Kanata, Ontario. Its design and production facilities are all ISO9001 compliant. Founded in 1984, PSP has grown to currently include more than 160 employees at its Canadian and U.S. facilities.

The Company did not achieve certain covenants as stipulated in its operating line credit facility with its principal Canadian lender (the "Bank") in certain prior periods. However, on May 12, 2010, the Company entered into an arrangement agreement (the "Arrangement Agreement") with Revision Eyewear Inc. ("Revision"). The Arrangement Agreement contemplated that all of the outstanding common shares of PSP would be purchased by Revision at a price of \$0.18 per Common Share, payable in cash at closing. On May 25, 2010, the Company was notified by the Bank that it would continue to waive the covenant violations, subject to no further deterioration in the Company's financial position, confirmation of shareholder approval of the acquisition by Revision and the payment in full of all outstanding lines of credit by June 30, 2010.

On June 15, 2010, the Company announced that it agreed with Revision to terminate the Arrangement Agreement as several of PSP's larger shareholders had indicated that they would not support the Arrangement Agreement, and it was apparent that there was insufficient shareholder support to obtain the required two-thirds approval of the shareholders. On August 18, 2010, the Company sold certain of PSP's headborne systems, in particular, the helmet liner capability, to Revision for \$275,000 and a 4% royalty on gross sales over a five-year period (the "Headborne Sale"). On September 14, 2010, Revision exercised an option to purchase the remainder of the headborne systems for an additional \$100,000 and a 2.5% royalty on gross sales over a five-year period.

On June 24, 2010, the Company was notified by the Bank that the Company had not met the conditions stipulated in its letter of May 25, 2010 and, as a result, the Company was subjected to, among other things; (i) a reduction in the operating line to \$3 million from \$5 million, (ii) more stringent reporting requirements, and (iii) preparing detailed projections for the 2011 fiscal year, showing maintenance of the Bank's covenants at all times.

The Company signed a forbearance agreement (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. During this Forbearance Period, the Company has been 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 again on February 23, 2011.

On August 17, 2010, the Company issued \$1.0 million of unsecured convertible debentures 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 has strengthened the capital position of PSP and is expected to allow it to take advantage of growth opportunities available to the Company.

The Company is in discussions with the Bank regarding normalization of the credit facility, and the Bank has agreed to extend the Forbearance Period until March 31, 2011 to complete the process. The working capital ratio at December 31, 2010, is 1.44 compared to 1.05 at June 30, 2010. The debt to tangible net worth ratio at December 31, 2010 is 2.33 compared to 9.06 at June 30, 2010.

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 obtain the ongoing support of its lenders and restore profitable operations.

Market Conditions

The Company continues to operate in a challenging environment as evidenced by decreased revenue and a recent history of losses. The reduced sales volume reflects reduced customer buying activity and increased competition as both domestic and foreign suppliers pursue market opportunities. While there have been some signs of improvement, management continues to monitor market conditions closely. Many of PSP's major customers are government departments and agencies at the federal, provincial, state and municipal levels. These organizations continue to operate under budget pressures as governments attempt to reduce spending in light of the current economic environment.

The market for law enforcement and security products in Canada has slowed compared to the same period last year. This market accounted for approximately 59.9% of the Company's revenue during the six months ended December 31, 2010, down from 67.7% for the same period last year. The Company's U.S. market for soft body armour continues to be affected by the economic recession, partially offset by General Services Administration ("GSA") business and sales to international customers. Currently the U.S. market accounts for approximately 40.1% of total revenue during the six months ended December 31, 2010, up from 32.3% for the same period last year.

Despite challenges in the market, PSP has launched its new NIJ.06-certified body armour product lines, and has recently won contracts for its new LiteX IIIA and LiteX II products with major police forces in British Columbia and Ontario initially worth over \$300,000 and with a follow on value of over \$800,000 in fiscal 2011 and fiscal 2012. PSP's body armour is known for its comfort, fit, reliability, and quality. Its LiteX product line combines a high level of ballistic protection with a flexible, light weight, and durable design that passes the stringent environmental and ballistic tests required to meet NIJ.06 certification. PSP's products are the only NIJ.06-certified body armour designed and manufactured in Canada, made at PSP's facility in Arnprior, Ontario. Its NIJ.06 certification provides for manufacturing in both its Arnprior and Dover plants. Police forces throughout the U.S. and Canada are in the process of upgrading their body armour to the NIJ.06 standard.

The Company's U.S. subsidiary, Sentry, received an order of over US\$2 million for its tactical body armour during the second quarter ending December 31, 2010. The body armour is sold under its GH Armor™ brand and is being manufactured at the Company's plant in Dover, Tennessee for delivery during the second and third quarters of fiscal 2011. This order is indicative of PSP's growth strategy for the U.S. market and represents customer confidence in PSP's ability to deliver a large volume of quality product over a tight time frame.

During the third quarter of fiscal 2011 the Company received a significant order for the supply of protective products to the Department of National Defence for manufacturing at the Arnprior, Ontario facility.

Part II: RESULTS

SUMMARY OF OPERATIONS	<i>THREE MONTHS ENDED DECEMBER 31, 2010</i>	<i>THREE MONTHS ENDED DECEMBER 31, 2009</i>	<i>SIX MONTHS ENDED DECEMBER 31, 2010</i>	<i>SIX MONTHS ENDED DECEMBER 31, 2009</i>
	SALES	\$ 5,054,148	\$ 7,437,348	\$ 9,356,099
COST OF SALES	3,949,093	5,773,117	7,301,651	12,254,275
GROSS MARGIN	1,105,055	1,664,231	2,054,448	2,812,454
EXPENSES	1,356,531	1,757,701	2,956,167	3,453,699
LOSS BEFORE OTHER ITEMS	(251,476)	(93,470)	(901,719)	(641,245)
OTHER ITEMS	108,258	143,571	223,591	210,978
LOSS BEFORE INCOME TAXES	(359,734)	(237,041)	(1,125,310)	(852,223)
INCOME TAX EXPENSE (RECOVERY)	–	(78,057)	–	(329,456)
NET AND COMPREHENSIVE LOSS	\$ (359,734)	\$ (158,984)	\$ (1,125,310)	\$ (522,767)
BASIC AND DILUTED LOSS PER SHARE	\$ (0.01)	\$ (0.01)	\$ (0.04)	\$ (0.02)
WEIGHTED AVERAGE BASIC COMMON SHARES ISSUED AND OUTSTANDING – BASIC AND DILUTED	26,072,331	25,654,605	25,906,742	25,654,605

FINANCIAL POSITION	<i>DECEMBER 31, 2010</i>	<i>JUNE 30, 2010</i>
TOTAL ASSETS	\$ 16,110,255	\$ 12,140,618
TOTAL LONG-TERM FINANCIAL LIABILITIES	\$ 1,623,156	\$ 946,580

Sales

Sales for the three months ended December 31, 2010 were \$5.1 million, a decrease of \$2.4 million or 32.0% as compared to the same period in the prior year. Sales from Canadian operations were \$3.2 million, a decrease of \$2.5 million, and sales from U.S. operations were \$1.9 million, an increase of \$0.1 million, compared to the same period in the prior year. The decrease in sales from Canadian operations is largely attributed to a decline in law enforcement product sales as a result of curtailed government spending in light of the current economic environment. Sales from U.S. operations increased due to the tactical body armour order received during the quarter.

Sales for the six months ended December 31, 2010 were \$9.4 million, a decrease of \$5.7 million or 37.9% as compared to the same period in the prior year. Sales from Canadian operations were \$5.7 million, a decrease of \$4.0 million, and sales from U.S. operations were \$3.7 million, a decrease of \$1.7 million. The decrease is largely attributed to a decline in law enforcement product sales in both Canada and the United States primarily as a result of curtailed government spending in light of the current economic environment.

Gross Margin

For three months ended December 31, 2010, gross margin as a percentage of sales was 21.9% consistent with gross margin of 22.4% during the same period in the prior year.

For the six months ended December 31, 2010, gross margin as a percentage of sales was 22.0%, which was an improvement over the gross margin of 18.7% during the same period in the prior year. The increase is primarily related to certain low margin products in the product mix in the six months ended December 31, 2009.

Expenses

For the three months ended December 31, 2010, expenses were \$1.4 million, a decrease of \$0.4 million or 22.8% as compared to the same period in the prior year.

For the three months ended December 31, 2010, sales and marketing expenses were \$0.4 million as compared to \$0.7 million during the same period in the prior year. The decrease is primarily related to reductions in headcount and other cost reduction initiatives compared to the same period in the prior year.

For the three months ended December 31, 2010, research and development expenses were \$0.08 million as compared to \$0.06 million during the same period in the prior year. The development costs expense is primarily related to the certification of certain product lines as required by the U.S. Department of Justice.

For the three months ended December 31, 2010, general and administration expense was \$0.7 million as compared to \$0.8 million during the same period in the prior year. A reduction in headcount resulted in a decrease in general and administrative expenses.

For the six months ended December 31, 2010, expenses were \$3.0 million, a decrease of \$0.5 million or 14.4% as compared to the same period in the prior year.

For the six months ended December 31, 2010, sales and marketing expenses were \$1.0 million as compared to \$1.5 million during the same period in the prior year. The decrease is primarily related to reductions in headcount and other cost reduction initiatives compared to the same period in the prior year.

For the six months ended December 31, 2010, research and development expenses were \$0.1 million consistent with the same period in the prior year. The development costs expense is primarily related to the certification of certain product lines as required by the U.S. Department of Justice.

For the six months ended December 31, 2010, general and administrative expenses were \$1.4 million consistent with the same period in the prior year.

Other Items

For the three months ended December 31, 2010, interest expense on the operating lines of credit and long-term debt was \$0.04 million, a decrease of 26.8% compared to the same period in the prior year due to reductions in amounts drawn on the operating lines of credit. Accrued interest on convertible debentures for the three months ended December 31, 2010 was \$0.03 million. For the three months ended December 31, 2010, the Company recorded an interest expense for accretion of the convertible debentures of \$0.03 million.

For the six months ended December 31, 2010, interest expense on the operating lines of credit and long-term debt was \$0.1 million, a decrease of 11.3% compared to same period in the prior year. Interest expense on operating lines includes a \$0.02 million forbearance fee for the first quarter of fiscal 2011. Accrued interest on convertible debentures for the six months ended December 31, 2010 was \$0.04 million. For the six months ended December 31, 2010, the Company recorded an interest expense for accretion of the convertible debentures of \$0.04 million. The debentures were issued in August 2010 and the interest and accretion expense represents a partial period in the first quarter of fiscal 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 three months ended December 31, 2010, the Company recorded a net and comprehensive loss of \$0.4 million as compared to a net and comprehensive loss of \$0.2 million during the same period in the prior year. The increase in net and comprehensive loss is primarily due to the reduction in sales partially offset by reduced expenses compared with the same period in the prior year, and a future income tax recovery recorded in the three months ended December 31, 2009.

For the six months ended December 31, 2010, the Company recorded a net and comprehensive loss of \$1.1 million as compared to net and comprehensive loss of \$0.5 million during the same period in the prior year. The increase in net and comprehensive loss is primarily due to the reduction in sales compared with the same period in the prior year, and a future income tax recovery recorded in the six months ended December 31, 2009.

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 three months ended December 31, 2010, Adjusted EBITDA loss was \$0.01 million compared to Adjusted EBITDA of \$0.2 million for the same period in the prior year. The decrease in Adjusted EBITDA compared with the prior year is primarily related to reduced sales volumes. For the three months ended December 31, 2010, Adjusted EBITDA improved by \$0.4 million compared to the immediately prior quarter reflecting the increase in sales quarter over quarter and the impact of cost savings initiatives.

For the six months ended December 31, 2010, Adjusted EBITDA was a loss of \$0.4 million compared to an Adjusted EBITDA loss of \$0.1 million during the same period in the prior year. The increase in the Adjusted EBITDA loss is primarily related to reduced sales volumes.

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

	<i>THREE MONTHS ENDED DECEMBER 31, 2010</i>	<i>THREE MONTHS ENDED DECEMBER 31, 2009</i>	<i>SIX MONTHS ENDED DECEMBER 31, 2010</i>	<i>SIX MONTHS ENDED DECEMBER 31, 2009</i>
Net and comprehensive loss	\$ (359,734)	\$ (158,984)	\$ (1,125,310)	\$ (522,737)
Interest expense	66,532	56,722	147,305	124,129
Interest expense – accretion of convertible debentures	24,627	–	36,448	–
Income taxes (recovery)	–	(78,057)	–	(329,456)
Stock-based compensation	–	8,255	–	15,681
Amortization	246,004	243,044	452,464	485,953
Loss on assets held for sale	17,099	–	39,838	–
One-time restructuring costs	–	86,849	–	86,849
Adjusted EBITDA	\$ (5,472)	\$ 157,829	\$ (449,255)	\$ (139,581)

Part III: CASH FLOW

	<i>THREE MONTHS ENDED DECEMBER 31, 2010</i>	<i>THREE MONTHS ENDED DECEMBER 31, 2009</i>	<i>SIX MONTHS ENDED DECEMBER 31, 2010</i>	<i>SIX MONTHS ENDED DECEMBER 31, 2009</i>
<i>Cash Flow From (Used In)</i>				
Operating activities	\$ 507,349	\$ 1,121,515	\$ 307,356	\$ (653,415)
Investing activities	(95,241)	(170,991)	(6,289)	(579,226)
Financing activities	1,518,903	(950,524)	1,629,944	1,012,659
	\$ 1,931,011	\$ –	\$ 1,931,011	\$ (219,982)

Cash flow from operating activities for the three months ended December 31, 2010 was \$0.5 million as compared to cash flow from operating activities of \$1.1 million for the same period in the prior year. The decrease in cash flow from operating activities was due to higher investment in working capital relative to sales.

Cash flow used in investing activities for the three months ended December 31, 2010 was \$0.1 million as compared to cash flow used in investing activities of \$0.2 million for the same period in the prior year. The decrease in cash used in investing activities was due to reduced investment in new product development.

Cash flow from financing activities for the three months ended December 31, 2010 was \$1.5 million as compared to cash flow used in financing activities of \$1.0 million for the same period in the prior year. The increase in cash flow was a result of cash proceeds from the share issue, net of share issue costs, of \$1.6 million, compared to a decrease in operating lines of credit of \$0.9 million during the same period in the prior year.

Cash flow from operating activities for the six months ended December 31, 2010 was \$0.3 million as compared to cash flow used in operating activities of \$0.6 million for the same period in the prior year. The increase in cash flow from operating activities is primarily due to reduced investment in working capital related to the decline in sales.

Part III: CASH FLOW (CONTINUED)

Cash flow used in investing activities for the six months ended December 31, 2010 was \$0.01 million as compared to cash flow used in investing activities of \$0.6 million during the same period in the prior year. The decrease in cash used investing activities was due to reduced spending on property and equipment and product development, and receipt of proceeds from the Headborne sale.

Cash flow from financing activities for the six months ended December 31, 2010, was \$1.6 million as compared to \$1.0 million during the same period in the prior year. The increase is primarily due to cash proceeds from the share issue, net of share issue costs, of \$1.6 million and proceeds from the issue of convertible debentures of \$0.9 million offset by a reduction in the operating lines of credit of \$0.9 million, compared to an increase of \$1.1 million in the operating lines of credit during the same period in the prior year.

Part IV: LIQUIDITY AND CAPITAL RESOURCES

<i>AS AT</i>	<i>DECEMBER 31, 2010</i>	<i>JUNE 30, 2010</i>
Operating lines of credit	\$ (1,507,879)	\$ (2,410,390)
Working capital	3,406,502	348,704
Long-term debt (long-term portion only)	(946,580)	(946,580)
Convertible debentures	(676,576)	—
Shareholders' equity	(6,778,160)	(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 anticipates minimal capital expenditures in 2011 primarily related to ongoing repairs and maintenance. In order to address the Company's cash requirements, a 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.

Working Capital

At December 31, 2010, PSP's working capital was \$3.4 million compared to \$0.3 million as at June 30, 2010. The increase in working capital is primarily related to the acquisition of net assets of Zuni including cash of \$1.9 million and restricted cash of \$2.6 million, and the reduction in operating lines of credit as a result of financing received through issue of convertible debentures and proceeds from the Headborne sale. Restricted cash is being held in escrow related to the sale of a Zuni subsidiary and other assets and, subject to any claims made against the escrow amounts, will be released in June 2011.

Accounts receivable as at December 31, 2010 was \$3.0 million, excluding Zuni receivables acquired, compared to \$4.2 million as at June 30, 2010. The decrease in accounts receivable reflects the decrease in sales in the six months ended December 31, 2010 compared to the six months ended June 30, 2010.

Inventory as at December 31, 2010 was \$2.7 million compared to \$2.3 million as at June 30, 2010. The increase reflects the inventory requirements and work in process related to the U.S. tactical body armour order received during the second quarter ending December 31, 2010.

Accounts payable and accrued liabilities as at December 31, 2010 was \$5.8 million compared to \$3.8 million at June 30, 2010. The increase includes Zuni liabilities acquired of \$1.8 million.

Operating lines of credit

PSP has 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 is secured by a first priority general security agreement over cash, Canadian accounts receivable and inventory. The maximum operating line is \$3.0 million and is subject to margin requirements and covenants set by the Bank. At December 31, 2010, the amount drawn on the line of credit was \$1.5 million.

PSP is required to meet certain covenants as outlined in its credit facility agreement with the Bank. In prior periods the Company did not meet certain covenants as stipulated in its credit facility. The Bank has agreed, pursuant to a Forbearance Agreement dated August 17, 2010, not to take steps to realize under the facility prior to February 28, 2011 unless a terminating event as defined in the Forbearance Agreement occurs. During this Forbearance Period, the Company has been subject to, and in compliance with, amended financial covenants. The Company is in discussion with the Bank regarding normalization of the credit facility, and the Bank has agreed to extend the Forbearance Period until March 31, 2011 to complete the process.

Operating lines of credit (continued)

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 US\$ 1.4 million and is subject to margin requirements and covenants set by the lenders. At December 31, 2010, the amount drawn on the line of credit was \$0.02 million.

Long-term Debt

The Company has a \$1.4 million secured term loan with the Business Development Bank of Canada ("BDC"). 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. At December 31, 2010, the principal outstanding on the loan was \$1.1 million. Principal payments resumed again on February 23, 2011.

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 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.

Certain Directors of the Company beneficially own, 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 December 31, 2010. These provisions include certain breaches or covenant violations of other credit facilities.

Future Income Taxes

At December 31, 2010, the Company had approximately \$3.9 million in Canadian non-capital tax loss carry forwards and US\$3.0 million in U.S. tax loss carry forwards available, excluding loss carry forwards of Zuni and its subsidiaries which have no operating business. As at December 31, 2010, the Company increased its income tax valuation allowance by \$0.2 million to \$3.2 million from \$3.0 million at June 30, 2010. The increase is primarily related to the lack of profitability of the Company in the past several years.

Equity Instruments and Other Paid-in Capital

At December 31, 2010, the Company's issued and outstanding shares were 56,209,487. 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 on behalf of 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.

The Company's contributed surplus balance was \$1.7 million at December 31, 2010 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.

Other paid-in capital of \$0.3 million at December 31, 2010 reflects the allocation of the equity component of convertible debentures, net of issue costs.

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 cash, restricted cash, accumulated debt, which is comprised of long-term debt, debentures, operating lines of credit 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 "Operating Lines of Credit", "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.

Capital Management (continued)

The Company must adhere to certain financial covenants related to debt. See “Operating Lines of Credit”, “Convertible Debentures” and “Long-term Debt”.

There have been no changes in the Company’s approach to capital management during the period.

Part V: QUARTERLY RESULTS

Fiscal 2011

	September 30, 2010	December 31, 2010
Sales	\$ 4,301,951	\$ 5,054,148
Net and comprehensive loss	(765,576)	(359,734)
Basic and diluted loss per share	(0.03)	(0.01)

Fiscal 2010

	September 30, 2009	December 31, 2009	March 31, 2010	June 30, 2010
Sales	\$ 7,629,381	\$ 7,437,348	\$ 7,698,489	\$ 7,077,862
Net and comprehensive loss	(363,783)	(158,984)	(87,378)	(2,439,037)
Basic and diluted loss per share	(0.01)	(0.01)	–	(0.09)

Fiscal 2009

	September 30, 2008	December 31, 2008	March 31, 2009	June 30, 2009
Sales	\$ 7,706,366	\$ 9,592,792	\$ 10,548,654	\$ 7,187,674
Net and comprehensive income (loss)	7,757	41,758	417,451	(9,677,628)
Basic and diluted loss per share	–	–	0.02	(0.38)

Significant Fluctuations in Quarterly Results

For the three months ended December 31, 2010, the Company recorded a loss from operations of \$0.4 million or \$0.01 per share. The decrease in the loss compared to the prior quarter is primarily due to increased sales and gross margin contribution 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 \$0.03 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.

Part VI: CRITICAL ACCOUNTING ESTIMATES, CHANGES TO ACCOUNTING POLICIES

Critical Accounting Estimates

In the MD&A for the year ended June 30, 2010, the Company disclosed the accounting policies which management believes are most subject to management’s estimation and judgment. As at December 31, 2010, it is management’s belief that there are no required changes to those accounting policies. During the six months ended December 31, 2010, the Company issued Convertible Debentures along with Warrants. As a result significant management estimates during the period include assumptions used in estimating the fair value of the Debentures, conversion feature and Warrants issued.

Future Changes in Accounting Standards

The Company formally commenced an IFRS conversion project in the fourth quarter of fiscal year 2008 and engaged the services of an external advisor with IFRS expertise to work with management. The Company has developed an IFRS changeover plan in preparation for the conversion to IFRS which addresses the following key elements:

- (i) Accounting policy changes and the impact on financial reporting
- (ii) Financial reporting expertise and training requirements
- (iii) Data systems and information technology impact
- (iv) Internal Control over financial reporting
- (v) Impact on business activities

An assessment was completed to examine the extent of the impact that the conversion may have on financial reporting, business processes, internal controls and information systems. The Company's plan is aimed in particular at identifying the differences between IFRS and the Company's current accounting policies, as well as assessing the impact of various accounting alternatives offered pursuant to IFRS. PSP's assessment of key areas, including Income Taxes, Foreign Exchange, and Property and Equipment continued in the second quarter of fiscal year 2011.

The Company will continue to evaluate these and other key areas in the coming quarter and plans to engage the services of an external consultant to assist in the process. The financial impact of the transition to IFRS cannot be reasonably estimated at this time.

Part VII: 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.

Going Concern

The Company reported a net loss of \$1.1 million for the six months ended December 31, 2010 and a deficit of \$15.3 million as at December 31, 2010. In addition, the Company has recently had to seek waivers from its lenders related to covenant violations on borrowings and entered into a forbearance agreement with its lenders. 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 obtain the ongoing support of its lenders and restore profitable operations.

No Record of Recent Profitability

The Company has incurred a loss of \$1.1 million during the six months ended December 31, 2010, and cumulative losses of \$12.4 million in the last three fiscal years, including \$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 retain 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 Bank and the U.S. operating lender are demand facilities. In the event the Company is in default under its credit agreements, the Bank may demand repayment of all amounts owing under the bank indebtedness and by virtue of the inter-lender agreement, the Lender and the U.S. operating lender may also demand repayment. There is also a cross default under the terms of the convertible debenture agreements, and the debenture holders have the right to demand repayment of their indebtedness should an event of default occur.

PSP is required to meet certain covenants as outlined in its credit facility with its Bank. In prior periods the Company did not meet certain covenants as stipulated in its credit facility. Pursuant to the Forbearance Agreement, the Bank agreed not to take steps to realize under the facility during the Forbearance Period unless a terminating event as defined in the Forbearance Agreement occurs. During the Forbearance Period, the Company has been subject to, and in compliance with, amended financial covenants. The Company is in discussion with the Bank regarding normalization of the credit facility, and the Bank has agreed to extend the Forbearance Period until March 31, 2011, to complete the process. Should the Company fail to meet any of the conditions imposed by its lender, it would in turn trigger events of default with the Company's other lenders. Management believes that this event would lead to significant uncertainty as the Company would be subject to the demands of its lenders.

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

Other Risks

Refer to the Company's June 30, 2010 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 VIII: OTHER INFORMATION

The authorized share capital of the Company consists of an unlimited number of common shares. As of February 28, 2011, there were 56,309,487 common shares outstanding. As of February 28, 2011, there were 2,202,800 options outstanding, excluding options approved for grant by the Board of Directors on February 28, 2011.

On August 6, 2010, the Board of Directors approved the grant of 2,100,000 stock options to certain executive officers and senior management, at an exercise price of \$0.10 in settlement of retention bonus obligations. The options were to vest prior to August 31, 2010 and would expire five years following the vesting date. However, in view of the number of options being available to be issued at the date of the grant being less than the amount of the grant, the Company has obtained TSX Venture Exchange approval to issue warrants in settlement of retention bonus obligations instead of the option grant, subject to acceptance by those executive officers and senior management.

Unaudited Interim Consolidated Financial Statements of

PACIFIC SAFETY PRODUCTS INC.

Six months ended December 31, 2010 and 2009

PACIFIC SAFETY PRODUCTS INC.
UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Notice to Reader

The accompanying unaudited interim consolidated financial statements have been prepared by and are the responsibility of the Company's management. The Company's independent auditor has not performed a review of these unaudited interim consolidated financial statements in accordance with the standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.



Douglas Lucky
Chief Executive Officer

February 28, 2011

PACIFIC SAFETY PRODUCTS INC.
CONSOLIDATED BALANCE SHEETS

	As at December 31, 2010	As at June 30, 2010
	(Unaudited)	
ASSETS		
CURRENT ASSETS		
Cash	\$ 1,931,011	\$ —
Restricted cash (note 3)	2,649,699	—
Accounts receivable	3,314,665	4,154,435
Inventory	2,701,962	2,258,874
Prepaid expenses and deposits	273,980	204,677
Investment tax credits recoverable	60,000	40,000
Assets held for sale (note 4)	184,124	250,215
Total current assets	11,115,441	6,908,201
PROPERTY AND EQUIPMENT	1,258,749	1,426,667
PRODUCT DEVELOPMENT COSTS	1,125,313	1,049,423
INTANGIBLE ASSETS	2,610,752	2,756,327
TOTAL ASSETS	\$ 16,110,255	\$ 12,140,618
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Operating lines of credit (note 5)	\$ 1,507,879	\$ 2,410,390
Accounts payable and accrued liabilities	5,834,886	3,841,698
Income taxes payable	99,893	—
Deferred revenue	69,821	93,089
Current portion of long-term debt (note 6)	196,460	214,320
Total current liabilities	7,708,939	6,559,497
LONG-TERM DEBT (note 6)	946,580	946,580
CONVERTIBLE DEBENTURES (note 7)	676,576	—
TOTAL LIABILITIES	9,332,095	7,506,077
SHAREHOLDERS' EQUITY		
Share capital (note 8)	20,079,555	17,614,731
Warrants (note 8)	45,500	—
Contributed surplus (note 9)	1,661,801	1,194,176
Other paid-in capital (note 7)	290,980	—
Deficit	(15,299,676)	(14,174,366)
Total shareholders' equity	6,778,160	4,634,541
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 16,110,255	\$ 12,140,618

Going concern (note 1)
Subsequent events (note 14)

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

PACIFIC SAFETY PRODUCTS INC.
UNAUDITED INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT

	Three months ended December 31, 2010	Three months ended December 31, 2009	Six months ended December 31, 2010	Six months ended December 31, 2009
SALES	\$ 5,054,148	\$ 7,437,348	\$ 9,356,099	\$ 15,066,729
COST OF SALES	3,949,093	5,773,117	7,301,651	12,254,275
GROSS MARGIN	1,105,055	1,664,231	2,054,448	2,812,454
EXPENSES				
Sales and marketing	437,389	706,113	1,024,073	1,493,104
Research and development	76,213	59,563	146,552	141,412
General and administration	654,613	753,551	1,422,399	1,427,598
Foreign exchange loss (gain)	(11,099)	51,974	3,094	24,719
Amortization of property and equipment	38,738	44,231	77,015	86,341
Amortization of product development costs and intangible assets	160,677	142,269	283,034	280,525
Total expenses	1,356,531	1,757,701	2,956,167	3,453,699
LOSS BEFORE OTHER ITEMS	(251,476)	(93,470)	(901,719)	(641,245)
OTHER ITEMS				
Interest on operating lines of credit	28,684	40,590	82,891	90,761
Interest on long-term debt	12,849	16,132	27,246	33,368
Interest on convertible debentures	24,999	-	37,168	-
Interest expense – accretion of convertible debentures (note 7)	24,627	-	36,448	-
Loss on assets held for sale (note 4)	17,099	-	39,838	-
Restructuring costs	-	86,849	-	86,849
Total other items	108,258	143,571	223,591	210,978
LOSS BEFORE INCOME TAXES	(359,734)	(237,041)	(1,125,310)	(852,223)
INCOME TAXES				
Current income tax expense	-	9,296	-	2,493
Future income tax recovery	-	(87,353)	-	(331,949)
Total income tax recovery	-	(78,057)	-	(329,456)
NET AND COMPREHENSIVE LOSS	(359,734)	(158,984)	(1,125,310)	(522,767)
DEFICIT, BEGINNING	(14,939,942)	(11,488,967)	(14,174,366)	(11,125,184)
DEFICIT, ENDING	\$ (15,299,676)	\$ (11,647,951)	\$ (15,299,676)	\$ (11,647,951)
LOSS PER SHARE (note 11)				
BASIC AND DILUTED	\$ (0.01)	\$ (0.01)	\$ (0.04)	\$ (0.02)
WEIGHTED AVERAGE COMMON SHARES ISSUED AND OUTSTANDING (note 11)				
BASIC AND DILUTED	26,072,331	25,654,605	25,906,742	25,654,605

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

PACIFIC SAFETY PRODUCTS INC.
UNAUDITED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOW

	Three months ended December 31, 2010	Three months ended December 31, 2009	Six months ended December 31, 2010	Six months ended December 31, 2009
OPERATING ACTIVITIES				
Cash receipts from customers	\$ 5,254,401	\$ 8,940,327	\$ 10,496,567	\$ 14,696,499
Cash paid to suppliers and employees	(4,705,519)	(7,722,794)	(10,079,074)	(15,163,292)
Interest paid	(41,533)	(56,722)	(110,137)	(124,129)
Other	-	(39,296)	-	(62,493)
CASH FLOW FROM (USED IN) OPERATING ACTIVITIES	507,349	1,121,515	307,356	(653,415)
INVESTING ACTIVITIES				
Purchase of property and equipment	(664)	(22,288)	(3,484)	(219,198)
Investment in new product development	(77,408)	(148,435)	(210,487)	(353,183)
Investment in intangible assets	(70)	(268)	(2,695)	(6,845)
Proceeds from sale of assets, net of selling costs	(17,099)	-	210,377	-
CASH FLOW USED IN INVESTING ACTIVITIES	(95,241)	(170,991)	(6,289)	(579,226)
FINANCING ACTIVITIES				
Proceeds from issue of convertible debentures, net of issue costs	-	-	935,000	-
Repayment of long-term debt	-	(53,580)	(17,860)	(107,160)
Increase (decrease) in operating lines of credit	(96,413)	(911,657)	(902,512)	1,105,106
Proceeds from the issue of equity instruments	-	14,713	-	14,713
Cash acquired pursuant to plan of arrangement (note 3)	1,892,642	-	1,892,642	-
Share issue costs (note 3)	(277,326)	-	(277,326)	-
CASH FLOW FROM (USED IN) FINANCING ACTIVITIES	1,518,903	(950,524)	1,629,944	1,012,659
INCREASE (DECREASE) IN CASH	1,931,011	-	1,931,011	(219,982)
CASH, BEGINNING	-	-	-	219,982
CASH, ENDING	\$ 1,931,011	\$ -	\$ 1,931,011	\$ -

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

PACIFIC SAFETY PRODUCTS INC.
NOTES TO THE UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
FOR THE SIX MONTHS ENDED DECEMBER 31, 2010 AND 2009

Pacific Safety Products Inc., incorporated under the Canada Business Corporations Act, manufactures, distributes and sells a complete line of protective products and accessories 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. APS Distributors ("APS") is a division of PSP located in Bedford, Nova Scotia and was acquired by PSP on October 31, 2007.

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.

1. GOING CONCERN

These unaudited 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 Pacific Safety Products Inc. ("PSP" or 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 reported a net loss of \$0.4 million and \$1.1 million for the three and six months ended December 31, 2010, respectively, and a deficit of \$15.3 million as at December 31, 2010. In addition, as described below, the Company in certain prior periods sought 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. During this Forbearance Period, the Company has been subject to, and in compliance with, amended financial covenants. The Company is in discussions with the Bank regarding normalization of the credit facility, and the Bank has agreed to extend the Forbearance Period until March 31, 2011 to complete the process.

A condition of the Company's Forbearance Agreement with its Bank required the Company to request from a Canadian lender (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 6). Principal payments resumed again on February 23, 2011.

On August 17, 2010, the Company issued \$1.0 million of unsecured convertible debentures in favour of a group of investors (note 7).

On December 31, 2010, the Company completed an amalgamation with Zuni Holdings Inc. by way of a Plan of Arrangement. The assets acquired included unrestricted cash of \$1.9 million (note 3).

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 obtain the ongoing support of its lenders and restore profitable operations. 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

The unaudited interim consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles ("Canadian GAAP") applicable to interim financial statements. In the opinion of management, the unaudited interim consolidated financial statements fairly present the financial position of the Company as at December 31, 2010. The results of operations are not indicative of operating results for the full year. The unaudited interim consolidated financial statements have been prepared utilizing the same accounting policies and methods of their application as the most recent audited consolidated annual financial statements as at and for the year ended June 30, 2010. The unaudited interim consolidated financial statements do not include all disclosures required according to Canadian GAAP for annual consolidated financial statements and should therefore be read in conjunction with the audited annual consolidated financial statements and notes thereto for the year ended June 30, 2010.

PACIFIC SAFETY PRODUCTS INC.
NOTES TO THE UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
FOR THE SIX MONTHS ENDED DECEMBER 31, 2010 AND 2009

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.

The Company also issued 2,000,000 replacement stock options and recorded the fair value of the options of \$106,400 in purchase consideration. 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:

	PSP
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 9)	(361,225)
Total purchase consideration	\$ 2,848,550

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, to be released June 11, 2011	\$ 2,550,240
Cash in escrow, to be released February 28, 2011	99,459
	<u>\$ 2,649,699</u>

Restricted cash is being held in escrow related to the sale of a Zuni subsidiary and other assets and, subject to any claims made against the escrow amounts, will be released.

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 six months ended December 31, 2010.

Proceeds from the sale, net of transaction costs, have been used to reduce the amount drawn on the operating line of credit.

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 asset classified as held for sale is measured at fair value less estimated costs to sell. The sale of this asset was completed on January 19, 2011 and net proceeds received were US\$187,376.

5. OPERATING LINES OF CREDIT

PSP has 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 is secured by a first priority general security agreement over cash, Canadian accounts receivable and inventory. The maximum operating line is \$3.0 million and is subject to margin requirements and covenants set by the Bank. At December 31, 2010, the amount drawn on the line of credit was \$1,492,404 (June 30, 2010 - \$1,875,094).

PSP is required to meet certain covenants as outlined in its credit facility agreement with the Bank. In prior periods the Company did not meet certain covenants as stipulated in its credit facility. The Bank agreed, pursuant to a letter agreement dated August 17, 2010 (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. During this Forbearance Period, the Company has been subject to, and in compliance with, amended financial covenants. The Company is in discussions with the Bank regarding normalization of the credit facility, and the Bank has agreed to extend the Forbearance Period until March 31, 2011 to complete the process.

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 US\$1.4 million and is subject to margin requirements and covenants set by the lenders. At December 31, 2010, the amount drawn on the line of credit was \$15,475 (June 30, 2010 - \$535,296).

PACIFIC SAFETY PRODUCTS INC.
NOTES TO THE UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
FOR THE SIX MONTHS ENDED DECEMBER 31, 2010 AND 2009

6. LONG-TERM DEBT

	As at December 31, 2010	As at June 30, 2010
Secured term loan with interest payable monthly calculated at the Lender's floating base rate of 5% at December 31, 2010 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 cash, receivables and inventory in favour of the bank providing a Canadian line of credit.		
A condition of the Company's Forbearance Agreement with its Canadian Chartered 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, 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 again on February 23, 2011.	\$ 1,143,040	\$ 1,160,900
Less current portion	(196,460)	(214,320)
	\$ 946,580	\$ 946,580

The principal instalments required over the next five years and thereafter are as follows:

Years ending December 31,	
2011	\$ 196,460
2012	214,320
2013	214,320
2014	214,320
2015	214,320
Thereafter	89,300
	\$ 1,143,040

7. 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 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.

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.

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7. CONVERTIBLE DEBENTURES (CONTINUED)

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 three and six months ended December 31, 2010, the Company recorded accretion expense of \$24,627 and \$36,448, respectively, 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, 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 December 31, 2010.

8. EQUITY INSTRUMENTS

(a) Share capital

Authorized

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

<i>Issued</i>	December 31, 2010		June 30, 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)	-	(277,326)	-	-
Ending balance	56,209,487	\$ 20,079,555	25,741,153	\$ 17,614,731

(b) Warrants

	December 31, 2010		June 30, 2010	
	Number of Warrants	Amount	Number of Warrants	Amount
Private placement – August 17, 2010 (note 7)	2,500,000	\$ 45,500	-	\$ -
Balance, end of period	2,500,000	\$ 45,500	-	\$ -

8. EQUITY INSTRUMENTS (continued)

(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 has a stock option plan that provides options to purchase common shares of the Company for its management, executive officers and members of the Board of Directors. These options expire five years after the issue date or, in the event the employee's service ceases, at a date determined by the Board of Directors. Board members' options expire 90 days after termination or resignation, 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.

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 December 31, 2010, the Company had 2,202,800 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, 2010	987,800	\$ 0.59
Expired	(785,000)	0.66
Issued pursuant to Plan of Arrangement (note 3)	2,000,000	0.10
Balance, December 31, 2010	2,202,800	\$ 0.12
Total Stock Option Pool Authorized		5,620,948
Total Stock Option Pool Remaining		3,418,148

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8. EQUITY INSTRUMENTS (continued)

(d) Stock options (continued)

The following table summarizes information regarding the Company's outstanding stock options at December 31, 2010:

<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 to \$0.17	2,105,000	4.40	\$ 0.10	2,105,000	\$ 0.10
\$0.43 to \$0.87	97,800	0.11	0.54	97,800	0.54
	2,202,800		\$ 0.12	2,202,800	\$ 0.12

On August 6, 2010, the Board of Directors approved the grant of 2,100,000 stock options to certain executive officers and senior management, at an exercise price of \$0.10 in settlement of retention bonus obligations. The options were to vest prior to August 31, 2010 and would expire five years following the vesting date. However, in view of the number of options being available to be issued at the date of the grant being less than the amount of the grant, the Company has obtained TSX Venture Exchange approval to issue warrants in settlement of retention bonus obligations instead of the option grant, subject to acceptance by those executive officers and senior management.

9. CONTRIBUTED SURPLUS

	Six months ended December 31, 2010	Year ended June 30, 2010
Balance, beginning of period	\$ 1,194,176	\$ 1,176,991
Fair value of options issued (note 3)	106,400	17,185
Excess value of net assets acquired over consideration paid (note 3)	361,225	–
Balance, end of period	\$ 1,661,801	\$ 1,194,176

10. 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 maintaining 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.

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10. CAPITAL DISCLOSURES (CONTINUED)

The Company considers its total capitalization to include all interest-bearing debt, including operating lines of credit, 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:

	As at December 31, 2010	As at June 30, 2010
Operating lines of credit	\$ 1,507,879	\$ 2,410,390
Current portion of long-term debt	196,460	214,320
Long-term debt	946,580	946,580
Convertible debentures	676,576	-
Funded debt	3,327,495	3,571,290
Shareholders' equity	6,778,160	4,634,541
Cash	(1,931,011)	-
Capital under management	\$ 8,174,644	\$ 8,205,831

There have been no changes in the Company's approach to capital management during the six months ended December 31, 2010.

11. LOSS PER SHARE

As the Company incurred a net loss during the three and six months ended December 31, 2010 and 2009, 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:

	As at December 31, 2010	As at June 30, 2010
Shares issuable on conversion of convertible debentures	10,000,000	-
Stock options	2,202,800	987,800
Warrants	2,500,000	-
	14,702,800	987,800

The Company issued 30,468,334 common shares on December 31, 2010, pursuant to the Plan of Arrangement (note 3). These common shares issued will have a dilutive effect in periods subsequent to December 31, 2010.

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12. 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 APS Distributors segments with operations based in Arnprior, Ontario and Bedford, Nova Scotia respectively, and in the U.S. through its Sentry subsidiary located in Dover, Tennessee.

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	Consolidated Total
<i>For the three months ended December 31, 2010</i>			
Revenue	\$ 3,212,643	\$ 1,854,414	\$ 5,067,057
Elimination of inter-segment revenue	(11,309)	(1,600)	(12,909)
Total revenue	3,201,334	1,852,814	5,054,148
Gross margin	787,952	317,103	1,105,055
Expenses	948,165	208,951	1,157,116
Amortization	146,764	52,651	199,415
Other items	103,506	4,752	108,258
Net loss	\$ (410,483)	\$ 50,749	\$ (359,734)

	Canadian Operations	U.S. Operations	Consolidated Total
<i>For the six months ended December 31, 2010</i>			
Revenue	\$ 5,703,614	\$ 3,739,120	\$ 9,442,734
Elimination of inter-segment revenue	(62,785)	(23,850)	(86,635)
Total revenue	5,640,829	3,715,270	9,356,099
Gross margin	1,211,885	842,563	2,054,448
Expenses	2,165,743	430,375	2,596,118
Amortization	261,307	98,742	360,049
Other items	198,555	25,036	223,591
Net loss	\$ (1,413,720)	\$ 288,410	\$ (1,125,310)

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12. SEGMENTED INFORMATION (CONTINUED)

	Canadian Operations	U.S. Operations	Consolidated Total
<i>For the three months ended December 31, 2009</i>			
Revenue	\$ 5,689,647	\$ 1,896,077	\$ 7,585,724
Elimination of inter-segment revenue	8,073	(156,449)	(148,376)
Total revenue	5,697,720	1,739,628	7,437,348
Gross margin	1,257,776	406,455	1,664,231
Expenses	1,095,967	475,234	1,571,201
Amortization	119,246	67,254	186,500
Other items	143,571	–	143,571
Income tax recovery	(78,057)	–	(78,057)
Net loss	\$ (22,951)	\$ (136,033)	\$ (158,984)

	Canadian Operations	U.S. Operations	Consolidated Total
<i>For the six months ended December 31, 2009</i>			
Revenue	\$ 9,697,398	\$ 5,697,046	\$ 15,394,444
Elimination of inter-segment revenue	(14,426)	(313,289)	(327,715)
Total revenue	9,682,972	5,383,757	15,066,729
Gross margin	2,143,388	669,066	2,812,454
Expenses	2,095,278	991,555	3,086,833
Amortization	233,394	133,472	366,866
Other items	210,978	–	210,978
Income tax recovery	(329,456)	–	(329,456)
Net loss	\$ (66,806)	\$ (455,961)	\$ (522,767)

	Corporate	Canadian Operations	U.S. Operations	Consolidated Total
AS AT DECEMBER 31, 2010				
<i>Assets</i>				
Current assets	\$ 5,098,911	\$ 3,874,264	\$ 2,142,266	\$ 11,115,441
Property and equipment	–	773,003	485,746	1,258,749
Intangible, other assets	–	2,459,778	1,276,287	3,736,065
	\$ 5,098,911	\$ 7,107,045	\$ 3,904,299	\$ 16,110,255

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12. SEGMENTED INFORMATION (continued)

	Canadian Operations	U.S. Operations	Consolidated Total
AS AT JUNE 30, 2010			
<i>Assets</i>			
Current assets	\$ 5,309,408	\$ 1,598,793	\$ 6,908,201
Property and equipment	880,079	546,588	1,426,667
Intangible, other assets	2,442,789	1,362,961	3,805,750
	\$ 8,632,276	\$ 3,508,342	\$ 12,140,618

Sales for the six months ended December 31	2010	2009
Domestic	\$ 5,601,554	\$ 10,195,472
United States	3,416,111	4,641,457
International	338,434	229,800
	\$ 9,356,099	\$ 15,066,729

Revenue for the six months ended December 31, 2010 includes sales of \$0.8 million to the Canadian Federal Government. Revenue for the six months ended December 31, 2009 includes sales of \$2.8 million to the Canadian Federal Government and sales of \$2.4 million to a U.S. federal government agency.

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.

13. COMPARATIVE FIGURES

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

14. SUBSEQUENT EVENTS

On February 28, 2011, the Board of Directors approved the grant of 1,025,000 stock options at an exercise price of \$0.10.