



Pacific Safety Products Inc.

REPORT TO SHAREHOLDERS

MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE
THREE MONTHS ENDED SEPTEMBER 30, 2011 and 2010

Management's Discussion and Analysis
September 30, 2011 and 2010
(in 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 December 20, 2011 and should be read together with the Company's unaudited condensed consolidated interim financial statements for the three months ended September 30, 2011, the audited annual consolidated financial statements and the notes thereto for the year ended June 30, 2011, and the Management Information Circular dated November 17, 2011. 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 IAS 34 *Interim Financial Reporting* and International Financial Reporting Standards ("IFRS"), except where otherwise stated, 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, 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 December 20, 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. Quarterly Results
- VI. Significant Accounting Policies and Estimates
- VII. Risks and Uncertainties
- VIII. 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, and 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 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 September 30, 2011, is 1.76 compared to 1.69 at June 30, 2011 and 1.05 at June 30, 2010. The debt to tangible net worth ratio at September 30, 2011 is 1.68 compared to 1.87 at June 30, 2011 and 25.9 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.

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, were used to reduce debt obligations.

On August 31, 2011, PSP signed an agreement ("Agreement") with a major Canadian bank (the "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.

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 primary focus at this stage in the transformation is adding value for its customers in conjunction with revenue stability and growth. In order to further strengthen the Company's financial position and address its liquidity requirements, the Company continues to consider and evaluate on an ongoing basis, all alternatives available to it. These alternatives include, without limitation, seeking additional sources of financing, identifying and pursuing strategic partnerships, and other value enhancing opportunities. However, there can be no assurance that such efforts will result in the Company pursuing any such alternative or, if pursued, there can be no assurance any such alternative will be successfully completed and implemented.

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	THREE MONTHS ENDED SEPTEMBER 30, 2011	THREE MONTHS ENDED SEPTEMBER 30, 2010
SALES	\$ 3,486,062	\$ 4,339,091
COST OF SALES	2,638,394	3,390,727
GROSS MARGIN	847,668	948,364
EXPENSES	1,327,486	1,523,446
LOSS BEFORE OTHER ITEMS	(479,818)	(575,082)
OTHER ITEMS	(176,122)	49,420
LOSS BEFORE INCOME TAXES	(303,696)	(624,502)
INCOME TAX EXPENSE (RECOVERY)	(6,319)	2,316
NET LOSS FOR THE PERIOD	\$ (297,377)	\$ (626,818)
OTHER COMPREHENSIVE INCOME (LOSS)	272,379	(131,534)
TOTAL COMPREHENSIVE LOSS FOR THE PERIOD	(24,998)	(758,352)
BASIC AND DILUTED LOSS PER SHARE	\$ (0.005)	\$ (0.024)
WEIGHTED AVERAGE BASIC COMMON SHARES ISSUED AND OUTSTANDING - BASIC AND DILUTED	56,869,741	25,741,153
FINANCIAL POSITION	AS AT SEPTEMBER 30, 2011	AS AT JUNE 30, 2011
TOTAL ASSETS	\$ 8,269,287	\$ 8,676,113
TOTAL LONG-TERM FINANCIAL LIABILITIES	\$ 1,555,239	\$ 1,581,916

Sales

Sales for the three months ended September 30, 2011 were \$3.5 million, a decrease of \$0.8 million or 19.7% as compared to \$4.3 million in the same period in the prior year. The decrease is attributed to a decline in the distribution business pursuant to its sale in May, 2011 and core law enforcement sales in both Canada and the United States. Sales to Canadian customers for the three months ended September 30, 2011 were \$1.6 million, a decline of \$0.8 million or 32.0% compared to the same period in the prior year. The decrease is primarily attributed to the decline in the distribution business pursuant to its sale in May, 2011 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 three months ended September 30, 2011 were \$1.8 million, a decrease of \$0.1 million or 4.0% compared to the prior year. The decrease is primarily related to a reduction in international law enforcement sales.

Gross Margin

For the three months ended September 30, 2011, gross margin as a percentage of sales was 24.3%, which was an increase over gross margin of 21.9% during the same period in the prior year. The increase is primarily related to product mix.

Operating Expenses

For the three months ended September 30, 2011, operating expenses were \$1.3 million, a decrease of \$0.2 million or 12.9% as compared to the same period in the prior year. The decrease in expenses is primarily related to cost reduction initiatives implemented over the last 12 months, lower commissions in connection with lower sales volumes, and lower amortization expense partially offset by expenses related to the entities acquired pursuant to the Plan of Arrangement.

For the three months ended September 30, 2011, 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 a reduction in head count, lower commissions, other cost reduction initiatives, and a reduction in amortization expense as a result of disposal and impairment of intangible assets compared to the same period in the prior year.

For the year three months ended September 30, 2011, research and development expenses were \$0.08 million as compared to \$0.12 million during the same period in 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. The reduction in expense is due to lower amortization expense as a result of impairment of product development costs capitalized.

For the three months ended September 30, 2011, general and administration expenses were \$0.8 million as compared to \$0.7 million during the same period in the prior year. The increase is primarily related to the management team being in place for the full quarter, professional fees related to IFRS implementation and expenses related to the entities acquired pursuant to the Plan of Arrangement, partially offset by cost reduction initiatives.

Foreign exchange losses (gains)

For the three months ended September 30, 2011, foreign exchange losses were \$0.09 million as compared to a gain of \$0.06 million during the same period in the prior year. The decrease is primarily related to the impact of devaluation of the Canadian dollar against the U.S. dollar with respect to purchases of materials in U.S. funds.

Finance costs

For the three months ended September 30, 2011, interest expense on bank indebtedness was \$0.01 million, a decrease from \$0.05 million during the prior year due to lower utilization and certain one-time charges incurred in the same period in the prior year. For the three months ended September 30, 2011, interest expense on the long-term debt was \$0.02 million.

For the three months ended September 30, 2011, interest on convertible debentures issued on August 17, 2010 was \$0.02 million and the Company recorded an interest expense for accretion of the convertible debentures of \$0.02 million, consistent with the same period in the prior year.

Onerous contract charges (settlement)

For the three months ended September 30, 2011, the net recovery related to onerous contracts was \$0.3 million with no comparable amount during the same period in the prior year.

On August 16, 2011 the Company signed a sublease for the remaining lease term for its former head office premises in Kanata, Ontario. The Company recognized a provision for the discounted future lease payments to which the Company is committed less expected future sublease income in the amount of \$0.1 million. Pursuant to the Plan of Arrangement the Company assumed a provision for discounted future lease payments related to the vacated manufacturing facility of a Zuni subsidiary that no longer had any operating business activities. A settlement was reached with the landlord and the lease was terminated on September 30, 2011 resulting in a release of the provision in the amount of \$0.4 million.

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 loss for the period

For the three months ended September 30, 2011, the Company recorded a net loss of \$0.3 million compared to a net loss of \$0.6 million during the same period in the prior year. The decrease in net loss is primarily due to settlement of certain property lease obligations.

Other comprehensive income (loss)

For the three months ended September 30, 2011, the Company recorded other comprehensive income of \$0.3 million compared to other comprehensive loss of \$0.1 million during the same period in the prior year. The increase in other comprehensive income is due to foreign currency translation differences relating to foreign operations.

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 loss and excludes interest, income tax expense (recovery), depreciation and amortization. Adjusted EBITDA excludes stock-based compensation, foreign exchange and one-time charges and gains. 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 loss for the period.

For the three months ended September 30, 2011 Adjusted EBITDA was a loss of \$0.4 million consistent with an Adjusted EBITDA loss of \$0.4 million during the same period in the prior year.

The following is a reconciliation of net loss for the period to Adjusted EBITDA:

	<i>THREE MONTHS ENDED SEPTEMBER 30, 2011</i>	<i>THREE MONTHS ENDED SEPTEMBER 30, 2010</i>
Net loss for the period	\$ (297,377)	\$ (626,818)
Foreign exchange losses (gains)	86,491	(64,389)
Finance costs, net	69,344	91,070
Income taxes (recovery)	(6,319)	2,316
Stock-based compensation	18,764	-
Depreciation and Amortization	89,772	192,942
Onerous contract charges (settlement)	(331,957)	-
Loss on assets sale of assets	-	22,739
Adjusted EBITDA	<u>\$ (371,282)</u>	<u>\$ (382,140)</u>

Part III: CASH FLOW

	<i>THREE MONTHS ENDED SEPTEMBER 30, 2011</i>	<i>THREE MONTHS ENDED SEPTEMBER 30, 2010</i>
<i>CASH FLOW FROM (USED IN)</i>		
Operating activities	\$ (402,293)	\$ (199,993)
Investing activities	(148,181)	88,952
Financing activities	21,385	111,041
Decrease in cash and cash equivalents	<u>\$ (529,089)</u>	<u>\$ -</u>

Cash flow used in operating activities for the three months ended September 30, 2011 was \$0.4 million as compared to cash flows used in operating activities of \$0.2 million during the same period in the prior year. The increased use of cash in operating activities is primarily due to the decline in sales and funding of losses.

Cash flow used in investing activities for the three months ended September 30, 2011 was \$0.1 million as compared to cash flow from

investing activities of \$0.1 million during same period in the prior year. Proceeds from the sale of assets were \$0.2 million in the same period in the prior year.

Cash flow from financing activities for the three months ended September 30, 2011 was \$0.02 million as compared to cash flow from financing activities of \$0.1 million during the same period in the prior year. During the three months ended September 30, 2011 an increase in bank indebtedness was offset by principal payments on long term debt. During the same period in the prior year, proceeds from the issuance of convertible debentures were used to reduce bank indebtedness.

Part IV: LIQUIDITY AND CAPITAL RESOURCES

AS AT	SEPTEMBER 30, 2011	JUNE 30, 2011
Cash and cash equivalents	\$ 2,405,445	\$ 2,897,735
Bank indebtedness	(767,991)	(693,026)
Working capital	2,766,376	2,868,874
Long-term debt (long-term portion only)	(785,840)	(839,420)
Convertible debentures	(769,399)	(742,496)
Shareholders' equity	(3,057,910)	(2,964,144)

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 September 30, 2011, PSP's working capital was \$2.8 million compared to \$2.9 million as at June 30, 2011. The decrease in working capital is primarily related to a reduction in cash and cash equivalents of \$0.5 million and bank indebtedness of \$0.1 million offset by a reduction in provisions of \$0.5 million.

Accounts receivable as at September 30, 2011 were \$2.4 million consistent with \$2.4 million as at June 30, 2011.

Inventories as at September 30, 2011 remained unchanged at \$1.3 million as compared to \$1.3 million as at June 30, 2011.

Accounts payable and accrued liabilities as at September 30, 2011 were \$2.3 million and is comparable to the \$2.3 million as at June 30, 2011.

Provisions as at September 30, 2011 were \$0.2 million compared to \$0.7 million as at June 30, 2011. The decrease reflects the recovery on settlement of a lease obligation in the three months ended September 30, 2011.

Bank Indebtedness

PSP had an agreement with a Canadian 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. On August 31, 2011 the amount drawn on the line of credit was repaid in full and the facility was closed.

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. At September 30, 2011, the amount drawn on the overdraft facility of \$0.8 million is included in bank indebtedness, and cash collateral held in a GIC with the Bank in the amount of \$1.0 million is included in cash and cash equivalents.

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 September 30, 2011, the amount drawn on the line of credit was \$Nil.

Long-term Debt

The Company has a \$1.4 million secured term loan with the Business Development Bank of Canada ("BDC" or the "Lender"). At September 30, 2011, the principal outstanding on the loan was \$1.0 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 had 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.

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 September 30, 2011.

Deferred Income Taxes

At September 30, 2011, the Company had approximately \$4.1 million in Canadian tax non-capital loss carryforwards and \$3.2 million in U.S. tax loss carryforwards available, excluding loss carryforwards of Zuni and its subsidiaries which have no operating business activities.

Equity Instruments and Other Paid-in Capital

At September 30, 2011, the Company's issued and outstanding shares were 57,454,895. At June 30, 2011, the Company's issued and outstanding shares were 56,309,487. On August 17, 2011 the Company issued 1,145,408 common shares in settlement of interest payable on convertible debentures in the amount of \$100,000.

The Company's contributed surplus balance was \$1.8 million at September 30, 2011 and June 30, 2011. Stock-based compensation expense for the three months ending September 30, 2011 was \$0.02 million.

Other paid-in capital of \$0.2 million at September 30, 2011 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 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 period.

Part V: QUARTERLY RESULTS

Fiscal 2012	September 30, 2011¹
Sales	\$ 3,486,062
Net loss for the period	(297,377)
Basic and diluted loss per share	(0.005)

Fiscal 2011	June 30, 2011 ²	March 31, 2011 ²	December 31, 2010 ²	September 30, 2010 ¹
Sales	\$ 4,943,820	\$ 8,286,012	\$ 5,094,773	\$ 4,339,091
Net loss for the period	(2,115,994)	(140,687)	(359,734)	(626,818)
Basic and diluted loss per share	(0.038)	(0.002)	(0.014)	(0.024)

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

¹ Presented in accordance with IFRS

² Presented in accordance with Canadian GAAP

Significant Fluctuations in Quarterly Results

As identified in the table above not all comparative quarterly information has been restated in accordance with IFRS. For this reason the value of the information for comparative purposes may be limited.

For the three months ended September 30, 2011, the Company recorded a net loss from operations of \$0.3 million or \$0.005 per share. The decrease in the loss compared to the prior quarter is due to the loss on sale of APS assets and disposal of certain intangible assets of \$1.5 million recorded in the prior quarter and settlement of an onerous contract obligation in the three months ended September 30, 2011.

Part VI: SIGNIFICANT ACCOUNTING POLICIES AND ESTIMATES

Transition to IFRS

The Company adopted IFRS for its condensed consolidated interim financial statements for the three months ended September 30, 2011. These condensed consolidated interim financial statements have been prepared in accordance with IAS 34 *Interim Financial Reporting* and IFRS 1 *First-time Adoption of International Financial Reporting Standards* has been applied. The effective date of transition for the Company was July 1, 2010 and comparative information in the financial statements has been restated in accordance with IFRS.

The Company's IFRS accounting policies are provided in note 3 to the condensed consolidated interim financial statements.

An explanation of how the transition to IFRS has affected the consolidated financial statements of the Company is provided in note 16 to the condensed consolidated interim financial statements. Reconciliations from previous Canadian Generally Accepted Accounting Principles to IFRS are provided in the note.

No material changes in internal control over financial reporting or disclosure controls and procedures resulted from the adoption and implementation of IFRS.

Use of estimates and judgments

The preparation of the condensed consolidated interim financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

In the process of applying the Company's accounting policies, management has made the following judgments, which have the most significant effect on the amounts recognized in the condensed consolidated interim financial statements:

Impairment of non-financial assets

Impairment exists when the carrying value of a non-financial asset or cash-generating unit exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The value in use calculation is based on a discounted cash flow model. The recoverable amount is most sensitive to the discount rate used for the discounted cash flow model as well as the expected future cash flows and the growth rates used.

Depreciation and amortization rates

In calculating the depreciation and amortization expense, management is required to make estimates of the expected useful lives of property and equipment and intangible assets.

Taxes

Deferred tax assets, if any, are recognized for all unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilized. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of future taxable profits together with future tax planning strategies.

Canadian GAAP to IFRS adjustments

The following is a summary of the significant changes resulting from the adoption of IFRS. For a full explanation of all changes refer to note 16 of the condensed consolidated interim financial statements for the three months ended September 30, 2011.

- The Company elected under IFRS 1 *First-time adoption of IFRS*, to measure certain items of property and equipment at fair value and to deem the fair value as the new carrying cost as of July 1, 2010. Fair value was determined by a third party certified asset appraiser and resulted in a \$0.3 million decrease in the value of property and equipment.
- The Company assessed the recoverable amount of its cash generating units at July 1, 2010 on transition to IFRS. The recoverable amount was based on a value in use calculation. Under Canadian GAAP, the recoverable amount was calculated on an undiscounted basis, using higher long-term growth assumptions than are permissible under IFRS, and no impairment was recognized. Under IFRS an impairment loss of \$0.2 million was recorded at July 1, 2010. A further impairment loss of \$1.1 million was recorded in the year ended June 30, 2011.
- Under IFRS the Company has determined that the functional currency of the U.S. operating subsidiary, Sentry Armor Systems Inc., is the U.S. dollar. Sales prices, labour and material costs of the U.S. operating subsidiary are determined in U.S. dollars which are primary indicators of the functional currency in accordance with IFRS. Under Canadian GAAP, the U.S. operating subsidiary was accounted for as an integrated foreign operation. The U.S. operating subsidiary is generating positive cash flows in U.S. dollars and is no longer dependent on funding from the Canadian parent company.
- The Company elected, under IFRS 1 *First-time adoption of IFRS*, to deem all foreign currency translation differences that arose prior to the date of transition to be nil at the date of transition. Foreign currency translation differences with respect to the U.S. operating subsidiary were \$0.1 million and \$0.3 million at September 30, 2010 and June 30, 2011, respectively, resulting in a reduction to foreign exchange losses recorded under Canadian GAAP. Under IFRS foreign currency translation differences are recorded in other comprehensive income.

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 upon 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 a casual pool of staff and cell-based manufacturing in which production staff is 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 \$0.3 million for the three months ended September 30, 2011 and a deficit of \$19.1 million as at September 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 incurred a loss of \$0.3 million during the three months ended September 30, 2011 and has cumulative losses of \$16.5 million in the last four fiscal years, including \$4.1 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 solutions 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.

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.

Part VIII: OTHER INFORMATION

The authorized share capital of the Company consists of an unlimited number of common shares. As of December 20, 2011, there were 57,454,895 common shares outstanding. As of December 20, 2011, there were 4,875,000 options outstanding.

Condensed Consolidated Interim Financial Statements of

PACIFIC SAFETY PRODUCTS INC.

Three months ended September 30, 2011 and 2010

(Unaudited)

PACIFIC SAFETY PRODUCTS INC.
CONDENSED CONSOLIDATED INTERIM STATEMENT OF FINANCIAL POSITION
(Unaudited)

(In Canadian dollars)

	September 30, 2011	June 30, 2011	July 1, 2010
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents (note 7)	\$ 2,405,445	\$ 2,897,735	\$ –
Accounts receivable	2,393,947	2,431,490	4,154,435
Inventories	1,325,174	1,349,006	2,258,874
Prepaid expenses and deposits	256,812	279,560	204,677
Investment tax credits recoverable	41,136	41,136	40,000
Assets held for sale	–	–	250,215
	6,422,514	6,998,927	6,908,201
NON-CURRENT ASSETS			
Property and equipment (note 5)	664,321	633,199	887,770
Intangible assets (note 6)	1,182,452	1,043,987	3,788,148
	1,846,773	1,677,186	4,675,918
TOTAL ASSETS	\$ 8,269,287	\$ 8,676,113	\$ 11,584,119
LIABILITIES AND EQUITY			
CURRENT LIABILITIES			
Bank indebtedness (note 7)	\$ 767,991	\$ 693,026	\$ 2,410,390
Accounts payable and accrued liabilities	2,282,835	2,323,137	3,692,787
Provisions (note 10)	219,680	721,398	148,911
Deferred revenue	66,529	73,134	93,089
Income taxes payable	104,783	105,038	–
Current portion of long-term debt (note 8)	214,320	214,320	214,320
	3,656,138	4,130,053	6,559,497
NON-CURRENT LIABILITIES			
Long-term debt (note 8)	785,840	839,420	946,580
Convertible debentures (note 9)	769,399	742,496	–
	1,555,239	1,581,916	946,580
TOTAL LIABILITIES	5,211,377	5,711,969	7,506,077
EQUITY			
Share capital (note 11)	20,180,222	20,080,222	17,614,731
Warrants (note 11)	–	45,500	–
Contributed surplus	1,832,291	1,768,027	1,194,176
Other paid-in capital	234,953	234,953	–
Deficit	(19,094,122)	(18,796,745)	(14,730,865)
Accumulated other comprehensive income	(95,434)	(367,813)	–
Total equity	3,057,910	2,964,144	4,078,042
TOTAL LIABILITIES AND EQUITY	\$ 8,269,287	\$ 8,676,113	\$ 11,584,119

Going concern (note 2(e))

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

PACIFIC SAFETY PRODUCTS INC.
CONDENSED CONSOLIDATED INTERIM STATEMENT OF COMPREHENSIVE INCOME
(Unaudited)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 and 2010
(In Canadian dollars)

	2011	2010
SALES	\$ 3,486,062	\$ 4,339,091
COST OF SALES	2,638,394	3,390,727
GROSS MARGIN	847,668	948,364
OPERATING EXPENSES		
Sales and marketing	442,124	667,772
Research and development	77,126	118,636
General and administration	808,236	737,038
Total operating expenses	1,327,486	1,523,446
LOSS BEFORE OTHER ITEMS	(479,818)	(575,082)
OTHER ITEMS		
Foreign exchange losses (gains)	86,491	(64,389)
Finance income (note 13)	(3,216)	–
Finance costs (note 13)	72,560	91,070
Onerous contract charges (settlement) (note 10)	(331,957)	–
Loss on sale of assets	–	22,739
Total other items	(176,122)	49,420
LOSS BEFORE INCOME TAXES	(303,696)	(624,502)
INCOME TAXES		
Current income tax expense (recovery)	(6,319)	2,316
NET LOSS FOR THE PERIOD	(297,377)	(626,818)
OTHER COMPREHENSIVE INCOME (LOSS)		
Foreign currency translation differences – foreign operations	272,379	(131,534)
TOTAL COMPREHENSIVE LOSS FOR THE PERIOD	\$ (24,998)	\$ (758,352)
LOSS PER SHARE (note 14)		
BASIC AND DILUTED	\$ (0.005)	\$ (0.024)
WEIGHTED AVERAGE COMMON SHARES ISSUED AND OUTSTANDING (note 14)		
BASIC AND DILUTED	56,869,741	25,741,153

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

PACIFIC SAFETY PRODUCTS INC.
CONDENSED CONSOLIDATED INTERIM STATEMENT OF CHANGES IN EQUITY
(Unaudited)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 and 2010
(In Canadian dollars)

	Share capital	Warrants	Contributed surplus	Other paid-in capital	Deficit	Cumulative translation account	Total
Balance, July 1, 2010	\$ 17,614,731	\$ –	\$ 1,194,176	\$ –	\$(14,730,865)	\$ –	\$ 4,078,042
Net loss for the period	–	–	–	–	(626,818)	–	(626,818)
Other comprehensive income (loss):							
Foreign currency translation differences	–	–	–	–	–	(131,534)	(131,534)
Total comprehensive loss	–	–	–	–	(626,818)	(131,534)	(758,352)
Issuance of warrants	–	45,500	–	–	–	–	45,500
Issuance of convertible debentures	–	–	–	234,953	–	–	234,953
Total amounts attributable to owners	–	45,500	–	234,953	–	–	280,453
Balance, September 30, 2010	\$ 17,614,731	\$ 45,500	\$ 1,194,176	\$ 234,953	\$(15,357,683)	\$ (131,534)	\$ 3,600,143
Balance, July 1, 2011	\$ 20,080,222	\$ 45,500	\$ 1,768,027	\$ 234,953	\$(18,796,745)	\$ (367,813)	\$ 2,964,144
Net loss for the period	–	–	–	–	(297,377)	–	(297,377)
Other comprehensive income (loss):							
Foreign currency translation differences	–	–	–	–	–	272,379	272,379
Total comprehensive income (loss)	–	–	–	–	(297,377)	272,379	(24,998)
Issuance of shares	100,000	–	–	–	–	–	100,000
Share-based compensation expense	–	–	18,764	–	–	–	18,764
Warrants expired	–	(45,500)	45,500	–	–	–	–
Total amounts attributable to owners	100,000	–	64,264	–	–	–	118,764
Balance, September 30, 2011	\$ 20,180,222	\$ –	\$ 1,832,291	\$ 234,953	\$(19,094,122)	\$ (95,434)	\$ 3,057,910

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

PACIFIC SAFETY PRODUCTS INC.
CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS
(Unaudited)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 and 2010
(In Canadian dollars)

	2011	2010
CASH FLOW FROM OPERATING ACTIVITIES		
Cash receipts from customers	\$ 3,620,922	\$ 5,240,752
Cash paid to suppliers and employees	(4,008,548)	(5,325,590)
Interest paid	(24,202)	(68,604)
Interest received	3,216	-
Income taxes recovered (paid)	6,319	(2,316)
NET CASH FROM (USED IN) OPERATING ACTIVITIES	(402,293)	(155,758)
CASH FLOW FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(58,139)	(2,820)
Investment in intangible assets	(90,042)	(135,704)
Proceeds from sale of assets, net of selling costs	-	227,476
NET CASH FROM (USED IN) INVESTING ACTIVITIES	(148,181)	88,952
CASH FLOW FROM FINANCING ACTIVITIES		
Proceeds from issue of convertible debentures, net of issue costs	-	935,000
Repayment of long-term debt	(53,580)	(17,860)
Increase (decrease) in bank indebtedness	74,965	(791,860)
NET CASH FROM (USED IN) FINANCING ACTIVITIES	21,385	125,280
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(529,089)	58,474
CASH AND CASH EQUIVALENTS, BEGINNING	2,897,735	-
Effect of exchange rate fluctuations on cash held	36,799	(58,474)
CASH AND CASH EQUIVALENTS, ENDING	\$ 2,405,445	\$ -
Cash and cash equivalents consist of:		
Cash (note 7)	\$ 1,705,445	\$ -
Guaranteed Investment Certificate	700,000	-
	\$ 2,405,445	\$ -

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

PACIFIC SAFETY PRODUCTS INC.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(Unaudited)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 and 2010
(In Canadian dollars)

1. REPORTING ENTITY

Pacific Safety Products Inc. ("PSP" or the "Company") is a company domiciled in Canada and incorporated under the Canada Business Corporation Act. The address of the Company's head office is 124 Fourth Avenue, Arnprior, Ontario K7S 0A9. The Company manufactures and sells a comprehensive line of protective products for the defence and security markets.

The condensed consolidated interim financial statements of the Company as at and for the three months ended September 30, 2011 comprise the Company and its subsidiaries. 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.

2. BASIS OF PREPARATION

(a) Statement of compliance

These condensed consolidated interim financial statements have been prepared in accordance with IAS 34 *Interim Financial Reporting*. These are the Company's first condensed consolidated interim financial statements prepared in accordance with International Financial Reporting Standards ("IFRS") and IFRS 1 *First-time Adoption of International Financial Reporting Standards* has been applied. The condensed consolidated interim financial statements do not include all of the information required for full annual consolidated financial statements.

An explanation of how the transition to IFRS has affected the reported financial position, financial performance and cash flows of the Company is provided in note 16. Reconciliations from previous Canadian Generally Accepted Accounting Principles ("Canadian GAAP") to IFRS are provided in the note.

The condensed consolidated interim financial statements were authorized for issue by the Board of Directors on December 19, 2011.

(b) Basis of measurement

These condensed consolidated interim financial statements have been prepared on the historical cost basis except as permitted by IFRS and as otherwise indicated within these notes.

(c) Functional and presentation currency

These condensed consolidated interim financial statements are presented in Canadian dollars, which is the Company's functional currency.

(d) Use of estimates and judgments

The preparation of the condensed consolidated interim financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

In the process of applying the Company's accounting policies, management has made the following judgments, which have the most significant effect on the amounts recognized in the condensed consolidated interim financial statements:

Impairment of non-financial assets

Impairment exists when the carrying value of a non-financial asset or cash-generating unit exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The value in use calculation is based on a discounted cash flow model. The recoverable amount is most sensitive to the discount rate used for the discounted cash flow model as well as the expected future cash flows and the growth rates used.

Depreciation and amortization rates

In calculating the depreciation and amortization expense, management is required to make estimates of the expected useful lives of property and equipment and intangible assets.

PACIFIC SAFETY PRODUCTS INC.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(Unaudited)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 and 2010
(In Canadian dollars)

Taxes

Deferred tax assets, if any, are recognized for all unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilized. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of future taxable profits together with future tax planning strategies.

(e) Going concern

These condensed consolidated interim financial statements have been prepared in accordance with IFRS 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 \$0.3 million for the three months ended September 30, 2011 and has a deficit of \$19.1 million as at September 30, 2011.

In order to further strengthen the Company's financial position and address its liquidity requirements, the Company continues to consider and evaluate on an ongoing basis, all alternatives available to it. These alternatives include, without limitation, seeking additional sources of financing, identifying and pursuing strategic partnerships, and other value enhancing opportunities. However, there can be no assurance that such efforts will result in the Company pursuing any such alternative or, if pursued, there can be no assurance any such alternative will be successfully completed and implemented.

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 condensed consolidated interim 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.

3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in these condensed consolidated interim financial statements and in preparing the opening IFRS statement of financial position at July 1, 2010 for the purposes of the transition to IFRS, unless otherwise indicated.

(a) Basis of consolidation

The condensed consolidated interim financial statements comprise the accounts of the Company and its wholly-owned subsidiaries.

Subsidiaries are consolidated from the date of acquisition, being the date on which the Company obtains control, and continue to be consolidated until the date that such control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the Company using consistent accounting policies. Intra-group balances and transactions, and any unrealized income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements.

(b) Foreign currency translation

Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of PSP and its subsidiaries at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortized cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period, and the amortized cost in foreign currency translated at the exchange rate at the end of the reporting period.

Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated to the functional currency at the exchange rate at the date that the fair value was determined.

Foreign currency differences are recognized in profit or loss.

PACIFIC SAFETY PRODUCTS INC.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(Unaudited)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2011 and 2010
(In Canadian dollars)

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Foreign operations

The assets and liabilities of foreign operations are translated to Canadian dollars at exchange rates in effect at the reporting date. The income and expenses of foreign operations are translated to Canadian dollars at the monthly average exchange rates as an approximation of the actual exchange rate at the date of the transaction.

Foreign currency differences are recognized in other comprehensive income in the cumulative translation account.

Foreign exchange gains or losses from a monetary item receivable from or payable to a foreign operation, the settlement of which is neither planned nor likely to occur in the foreseeable future and which in substance is considered to form part of the net investment in the foreign operation, are recognized in other comprehensive income in the cumulative amount of foreign currency translation differences.

(c) Revenue recognition

Revenue is recognized when persuasive evidence exists that the risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, the costs incurred or to be incurred in respect of the transaction can be measured reliably, there is no continuing management involvement with the goods, and the amount of revenue can be measured reliably. Amounts received from customers prior to the shipment of products are recognized as deferred revenue in the period received and recorded as revenue when the products are shipped.

(d) Taxes

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to items recognized directly in equity or in other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the period, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous periods.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognized for the following temporary differences: the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss, and differences relating to investments in subsidiaries to the extent that it is probable that they will not reverse in the foreseeable future. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences, to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

(e) Government assistance

Government grants and assistance are recognized when there is reasonable assurance that the grant or assistance will be received and all attached conditions will be complied with. When the grant or assistance relates to an expense item, it is recognized as income over the period necessary to match the grant or assistance on a systematic basis to the costs that it is intended to compensate. Where the grant relates to an asset, it reduces the carrying amount of the asset. The grant is then recognized as income over the useful life of a depreciable asset by way of a reduced depreciation charge.

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.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(f) Financial instruments

(i) Non-derivative financial assets

Initial recognition and measurement

Financial assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* are classified as financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, available-for-sale financial assets, or as derivatives designated as hedging instruments in an effective hedge, as appropriate. The Company determines the classification of its financial assets at initial recognition.

All financial assets are recognized initially at fair value plus, in the case of financial assets not at fair value through profit or loss, directly attributable transaction costs.

The Company's financial assets include cash and cash equivalents and accounts receivable.

Subsequent measurement

The subsequent measurement of financial assets depends on their classification.

Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss includes financial assets held for trading and financial assets designated upon initial recognition at fair value through profit or loss. Financial assets are classified as held for trading if they are acquired for the purpose of selling or repurchasing in the near term. Financial assets at fair value through profit and loss are carried in the statement of financial position at fair value with changes in fair value recognized in finance income or finance cost in the statement of comprehensive income.

Cash and cash equivalents consist of bank balances and short-term investments that are redeemable in three months or less. The Company uses the direct method of reporting cash flow from operating activities.

Loans and receivables

Loans and receivables are financial assets with fixed or determinable payments that are not quoted in an active market. After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate method, less any impairment losses.

Loans and receivables comprise accounts receivable.

Derecognition

The Company derecognizes a financial asset when the contractual rights to the cash flows from the asset expire, or it transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Company is recognized as a separate asset or liability.

(ii) Non-derivative financial liabilities

Initial recognition and measurement

Financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* are classified as financial liabilities at fair value through profit or loss or other financial liabilities. The Company determines the classification of its financial liabilities at initial recognition.

All financial liabilities are recognized initially at fair value plus any directly attributable transaction costs.

The Company's financial liabilities including accounts payable and accrued liabilities, bank indebtedness, convertible debentures and long-term debt, are classified as other financial liabilities.

Subsequent measurement

Subsequent to initial recognition, the Company's financial liabilities are measured at amortized cost using the effective interest method.

3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(f) Financial instruments (continued)

Derecognition

The Company derecognizes a financial liability when its contractual obligations are discharged or cancelled or expire.

(iii) Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount presented in the statement of financial position when, and only when, there is a currently enforceable legal right to offset the recognized amounts and the Company intends to settle on a net basis or to realize the asset and settle the liability simultaneously.

(iv) Share capital

Common shares

Common shares are classified as equity. Incremental costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any tax effects.

Warrants

Warrants are classified as equity. Incremental costs directly attributable to the issue of warrants are recognized as a deduction from equity, net of any tax effects. The fair value of warrants is estimated using the Black-Scholes option pricing model.

(v) Compound financial instruments

Compound financial instruments issued by the Company comprise convertible debentures that can be converted to share capital at the option of the holder, and the number of shares to be issued does not vary with changes in their fair value.

The liability component of a compound financial instrument is recognized initially at the fair value of a similar liability that does not have an equity conversion option. The equity component is recognized initially at the difference between the fair value of the compound financial instrument as a whole and the fair value of the liability component. Any directly attributable transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts.

Subsequent to initial recognition, the liability component of a compound financial instrument is measured at amortized cost using the effective interest method. The equity component of a compound financial instrument is not remeasured subsequent to initial recognition.

Interest, losses and gains relating to the financial liability are recognized in profit or loss.

(g) Property and equipment

Property and equipment is measured at cost, net of accumulated depreciation and accumulated impairment losses, if any. Cost includes expenditure that is directly attributable to the acquisition of the asset.

On transition to IFRS from previous Canadian GAAP the Company elected, under IFRS 1 *First-time adoption of IFRS*, to measure certain items of property and equipment at fair value and to deem the fair value as the new carrying cost as of July 1, 2010, the date of transition to IFRS (note 16).

Gains and losses on disposal of an item of property and equipment are determined by comparing the proceeds from disposal with the carrying amount of property and equipment, and are recognized net within other income in profit or loss. The cost of replacing a part of an item of property and equipment is recognized in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Company, and its cost can be measured reliably. The carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in profit or loss as incurred.

Depreciation is calculated over the depreciable amount, which is the cost of an asset, or other amount substituted for cost, less its residual value.

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3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(g) Property and equipment (continued)

Depreciation of property and equipment is calculated using the following methods and annual rates:

Office equipment	20% to 30% diminishing balance
Manufacturing equipment	20% to 35% diminishing balance
Computer equipment	30% to 40% diminishing balance
Leasehold improvements	Terms of the leases

The assets' residual values, useful lives, and methods of depreciation are reviewed at each financial year end and adjusted if appropriate. Any changes in these estimates are accounted for prospectively.

(h) Leased assets

Finance leases, which transfer to the Company substantially all the risks and benefits incidental to ownership of the leased item, are capitalized at the commencement of the lease at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are recognized in the statement of comprehensive income.

Operating lease payments are recognized as an expense in the statement of comprehensive income on a straight line basis over the lease term.

(i) Intangible assets

Research and development costs include out-of-pocket costs and direct overheads. Research costs are expensed as incurred and are reduced by related government assistance and tax incentives.

Product development costs are capitalized only if development costs can be measured reliably, the product is technically and commercially feasible, future economic benefits are probable, and the Company intends to and has sufficient resources to complete development and to use or sell the asset. The expenditure capitalized includes the cost of materials, direct labour, and overhead costs that are directly attributable to preparing the asset for its intended use. Other development expenditure is recognized as an expense in the statement of comprehensive income as incurred.

Capitalized product development costs are measured at cost less accumulated amortization and accumulated impairment losses.

Other intangible assets acquired separately are measured on initial recognition at cost which represents the fair market value at the date of the acquisition. Following initial recognition, intangible assets are carried at cost less accumulated amortization and accumulated impairment losses.

Amortization of intangible assets is recognized in the statement of comprehensive income on a straight-line basis over the estimated useful lives of intangible assets from the date they are available for use. The estimated useful lives are as follows:

Product development costs	5 years
Patents and trademarks	5 years
Customer relationships	10 to 15 years
Trade names	15 years
Software	3 to 5 years

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3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(j) Inventories

Inventories are measured at the lower of weighted average cost and net realizable value.

Costs incurred in bringing inventories to their existing location and condition is accounted for as follows:

Raw materials - Purchase cost on a weighted average basis

Finished goods and work-in-progress - Cost of direct materials and labour and a proportion of manufacturing overheads based on normal operating capacity

Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

(k) Impairment

(i) Financial assets

The Company assesses at each reporting date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (an incurred 'loss event') and that loss event has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated. Evidence of impairment may include indications that the debtors or a group of debtors is experiencing significant financial difficulty, default, or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganization and where observable data indicates that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

If there is objective evidence that an impairment loss has incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows. The present value of the estimated future cash flows is discounted at the financial asset's original effective interest rate.

Losses are recognized in profit or loss and reflected in an allowance account against the asset. When a subsequent event causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

(ii) Non-financial assets

The Company assesses at each reporting date whether there is an indication that a non-financial asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, the Company estimates the asset's recoverable amount. An asset's recoverable amount is the higher of its fair value less costs to sell and its value in use. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or cash-generating unit. In determining fair value less costs to sell, an appropriate valuation model is used.

An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss and are allocated to reduce the carrying amounts of the assets in the CGU on a pro rata basis.

An assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. A previously recognized impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation or amortization, had no impairment loss been recognized in prior periods.

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3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(l) Share-based payment transactions

Compensation expense for stock options granted is measured at the grant-date fair value, using the Black-Scholes option valuation model. The Company recognizes estimated compensation expense related to stock options over the period that the employees and directors unconditionally become entitled to the awards, with the related credit being charged to contributed surplus.

(m) Provisions

A provision is recognized if the Company has a present legal or constructive obligation, as a result of a past event, that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. The expense relating to any provision is presented in profit or loss net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as a finance cost.

Warranties

A provision for warranties is recognized when the underlying products are sold. The provision is based on historical warranty data.

Onerous contracts

A provision for onerous contracts is recognized when the expected benefits to be derived by the Company from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract. Before a provision is established, the Company recognizes any impairment loss on the assets associated with that contract.

(n) Loss per share

The Company presents basic and diluted loss per share data for its common shares. Basic loss per share is calculated by dividing the profit or loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period, adjusted for own shares held. Diluted loss per share is determined by adjusting the profit or loss attributable to common shareholders and the weighted average number of common shares outstanding, adjusted for own shares held, for the effects of all dilutive potential common shares, which comprise convertible debentures and stock options granted to employees.

(o) Segment reporting

An operating segment is a component of the Company that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Company's other components. All operating segments' operating results are reviewed regularly by the Company's Chief Executive Officer ("CEO") to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available.

Segment results that are reported to the CEO include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Unallocated items comprise mainly corporate assets, public company and head office expenses, and income tax assets and liabilities.

(p) New standards and interpretations not yet adopted

A number of new standards, and amendments to standards and interpretations, are not yet effective for the year ended June 30, 2012, and have not been applied in preparing these condensed consolidated interim financial statements. None of these are expected to have a significant effect on the consolidated financial statements of the Company.

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4. 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
	5,098,911
Liabilities assumed:	
Accounts payable and accrued liabilities	(1,789,243)
Income taxes payable	(99,893)
	(1,889,136)
Excess value of net assets acquired over consideration paid	(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.

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5. PROPERTY AND EQUIPMENT

	Manufacturing equipment	Office equipment	Computer equipment	Leasehold improvements	Total
Cost or deemed cost					
As at July 1, 2010	\$ 603,903	\$ 109,162	\$ 48,653	\$ 229,131	\$ 990,849
Additions	7,933	–	16,770	–	24,703
Disposals	–	(59,267)	(33,267)	(39,606)	(132,140)
Effect of movements in exchange rates	(28,997)	(781)	(529)	(2,032)	(32,339)
As at June 30, 2011	582,839	49,114	31,627	187,493	851,073
Additions	4,349	–	163	53,627	58,139
Disposals	–	–	–	(10,436)	(10,436)
Effect of movements in exchange rates	24,559	653	511	7,503	33,226
As at September 30, 2011	\$ 611,747	\$ 49,767	\$ 32,301	\$ 238,187	\$ 932,002
Depreciation and impairment losses					
As at July 1, 2010	\$ –	\$ 45,711	\$ 31,951	\$ 25,417	\$ 103,079
Depreciation	176,709	16,500	7,566	31,102	231,877
Disposals	–	(49,448)	(32,809)	(28,927)	(111,184)
Effect of movements in exchange rates	(5,336)	(144)	(158)	(260)	(5,898)
As at June 30, 2011	171,373	12,619	6,550	27,332	217,874
Depreciation	31,391	2,378	2,149	9,278	45,196
Disposals	–	–	–	(1,864)	(1,864)
Effect of movements in exchange rates	5,667	152	174	482	6,475
As at September 30, 2011	\$ 208,431	\$ 15,149	\$ 8,873	\$ 35,228	\$ 267,681
Net book value					
As at June 30, 2011	\$ 411,466	\$ 36,495	\$ 25,078	\$ 160,160	\$ 633,199
As at September 30, 2011	\$ 403,316	\$ 34,618	\$ 23,428	\$ 202,959	\$ 664,321

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6. INTANGIBLE ASSETS

	Product development	Patents and trademarks	Tradenames	Software	Customer relationships	Total
Cost						
As at July 1, 2010	\$ 1,668,232	\$ 138,966	\$ 525,233	\$ 649,793	\$ 2,947,796	\$ 5,930,020
Additions	288,441	5,069	–	–	–	293,510
Disposals	–	–	–	–	(1,644,146)	(1,644,146)
Effect of movements in exchange rates	–	–	(49,385)	(5,910)	(122,577)	(177,872)
As at June 30, 2011	1,956,673	144,035	475,848	643,883	1,181,073	4,401,512
Additions	89,524	519	–	–	–	90,042
Effect of movements in exchange rates	–	–	41,294	4,941	102,494	148,730
As at September 30, 2011	\$ 2,046,197	\$ 144,554	\$ 517,142	\$ 648,824	\$ 1,283,567	\$ 4,640,284
Amortization and impairment losses						
As at July 1, 2010	\$ 663,896	\$ 99,237	\$ 110,877	\$ 497,341	\$ 770,521	\$ 2,141,872
Amortization	316,905	13,564	36,702	44,740	224,064	635,975
Impairment	975,872	31,234	–	88,894	–	1,096,000
Disposals	–	–	–	–	(437,790)	(437,790)
Effect of movements in exchange rates	–	–	(15,404)	(5,086)	(58,042)	(78,532)
As at June 30, 2011	1,956,673	144,035	132,175	625,889	498,753	3,357,525
Amortization	255	4	9,176	1,171	33,970	44,576
Effect of movements in exchange rates	–	–	10,914	3,676	41,141	55,731
As at September 30, 2011	\$ 1,956,928	\$ 144,039	\$ 152,265	\$ 630,736	\$ 573,864	\$ 3,457,832
Net book value						
As at June 30, 2011	\$ –	\$ –	\$ 343,673	\$ 17,994	\$ 682,320	\$ 1,043,987
At September 30, 2011	\$ 89,269	\$ 515	\$ 364,877	\$ 18,088	\$ 709,703	\$ 1,182,452

Impairment

Due to continuing losses, negative cash flow from operating activities, and the reduction in projected revenue in Canada following the sale of the distribution division, the Company assessed the recoverable amount of its cash generating units (“CGUs”). The recoverable amount of the CGUs was based on a value in use calculation.

Value in use was based on cash flows expected to be generated from each of the Company’s two CGUs. The two CGUs are assets of the Canadian (“Canada”) and U.S. operations (“USA”). Cash flows were projected up to the date that the assets within the CGUs are expected to be consumed by the entity. For Canada the expected life of the CGU was 6 years and the life of the USA CGU was 6 years. The key assumptions used in the value in use calculations of the CGUs are:

- Expected life of the CGUs’ assets
- Projection of cash inflows and outflows
- Discount rates

The value in use was determined using pre-tax discount rates of 25.15% and 25.55% for the Canada and USA CGUs, respectively. The discount rates applied reflect the Company’s weighted average cost of capital adjusted for the risks specific to the CGU.

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Cash flows were projected based on past experience, actual operating results and the Company's operating plan extrapolated for a 5 year period. A zero growth rate was assumed beyond year 5.

Based on the value in use assessment, the carrying amount of the Canada CGU at June 30, 2011 was determined to be \$1,096,000 higher than its recoverable amount and an impairment loss was recognized. The impairment loss was allocated pro rata to the intangible assets comprising the Canada CGU. The recoverable amount of the USA CGU based on the value in use calculation exceeded the carrying amount therefore no impairment loss was recognized.

7. BANK INDEBTEDNESS

PSP had an agreement with a Canadian 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. On August 31, 2011 the amount drawn on the line of credit was repaid in full and the facility was closed.

PSP signed an Agreement with another Canadian bank (the "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. At September 30, 2011, the amount drawn on the overdraft facility of \$767,991 is included in bank indebtedness, and cash collateral held in a GIC with the Bank in the amount of \$1,040,000 is included in cash and cash equivalents.

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 September 30, 2011, the amount drawn on the line of credit was \$Nil (June 30, 2011 - \$Nil).

8. LONG-TERM DEBT

	September 30, 2011	June 30, 2011
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.		
The Lender agreed to a six-month postponement of principal payments 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.	\$ 1,000,160	\$ 1,053,740
Less current portion	(214,320)	(214,320)
	\$ 785,840	\$ 839,420

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

Years ending September 30,		
2012	\$	214,320
2013		214,320
2014		214,320
2015		214,320
2016		142,880
	\$	<u>1,000,160</u>

9. 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 fair values of the Debentures (\$700,049) and Warrants (\$45,500) with the residual being allocated to the Conversion Option (\$254,451). The fair value of the Debentures is classified as a liability, while the 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 three months ended September 30, 2011, the Company recorded accretion expense of \$23,359 (three months ended September 30, 2010 - \$10,297) 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 (\$45,503) and to equity issuance costs (\$19,497) based on the relative fair values of the debt and equity components.

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

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

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 September 30, 2011.

10. PROVISIONS

The provision for warranties is based on estimates made from historical data associated with similar products. At September 30, 2011 the warranty liability was \$82,777 (June 30, 2011 - \$73,252; July 1, 2010 - \$46,221).

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During the year ended June 30, 2010, the Company implemented a restructuring plan directed at reducing costs. The balance in the restructuring provision at September 30, 2011 was \$16,379 (June 30, 2011 - \$16,379; July 1, 2010 - \$102,690).

On August 16, 2011 the Company signed a sublease for the remaining lease term for its former head office premises in Kanata, Ontario. The Company recognized a provision for the discounted future lease payments to which the Company is committed less expected future sublease income in the amount of \$122,308. The balance in the provision for onerous contracts at September 30, 2011 was \$120,524.

Pursuant to the Plan of Arrangement (note 4) the Company assumed a provision for discounted future lease payments related to the vacated manufacturing facility of a Zuni subsidiary that no longer had any operating business activities. The balance on the provision for this onerous contract at June 30, 2011 was \$631,767. A settlement was reached with the landlord and the lease was terminated on September 30, 2011 resulting in a release of the provision in the amount of \$462,838. The amount payable on settlement was reclassified to accounts payable and accrued liabilities as of September 30, 2011.

11. EQUITY INSTRUMENTS

(a) Authorized and issued

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

	September 30, 2011		June 30, 2011	
	Number of Shares	Amount	Number of Shares	Amount
Beginning balance	56,309,487	\$ 20,080,222	25,741,153	\$ 17,614,731
Shares issued under the Plan of Arrangement (note 4)	-	-	30,468,334	2,742,150
Share issue costs (note 4)	-	-	-	(283,659)
Shares issued in settlement of Debenture interest	1,145,408	100,000	-	-
Restricted shares	-	-	100,000	7,000
Balance, end of period	57,454,895	\$ 20,180,222	56,309,487	\$ 20,080,222

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

	September 30, 2011		June 30, 2011	
	Number of Warrants	Amount	Number of Warrants	Amount
Private placement – August 17, 2010	2,500,000	\$ 45,500	2,500,000	\$ 45,500
Expired unexercised – August 17, 2011	(2,500,000)	(45,500)	-	-
Balance, end of period	-	\$ -	2,500,000	\$ 45,500

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11. EQUITY INSTRUMENTS (CONTINUED)

(c) 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.

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 September 30, 2011, the Company had 4,875,000 stock options outstanding with an exercise price of \$0.10.

	<i>Total</i>	<i>Weighted Average Exercise Price</i>
Balance, June 30, 2011	4,884,000	\$ 0.10
Expired	(9,000)	0.79
Balance, September 30, 2011	4,875,000	\$ 0.10
Total Stock Option Pool Authorized		5,745,489
Total Stock Option Pool Remaining		870,489

The following table summarizes information regarding the Company's outstanding stock options at September 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	4.23	\$ 0.10	3,766,667	\$ 0.10

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12. OPERATING SEGMENTS

The Company's principal business activity is the manufacture and sale of a comprehensive line of protective products and accessories for the defence and security market. The Company operates in Canada through its PSP and formerly APS Distributors divisions with operations based in Annprior, 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 4) are reported as Corporate assets.

	Canadian Operations	U.S. Operations	Corporate	Consolidated Total
<i>For the three months ended September 30, 2011</i>				
Revenue	\$ 1,663,506	\$ 1,844,936	\$ –	\$ 3,508,442
Elimination of inter-segment revenue	(15,591)	(6,789)	–	(22,380)
Total revenue	1,647,915	1,838,147	–	3,486,062
Gross margin	401,558	446,110	–	847,668
Operating expenses	630,439	275,618	421,429	1,327,486
Other items	289,403	529	(466,054)	(176,122)
Income tax expense (recovery)	–	–	(6,319)	(6,319)
Net income (loss) after taxes	\$ (518,284)	\$ 169,963	\$ 50,944	\$ (297,377)

	Canadian Operations	U.S. Operations	Corporate	Consolidated Total
<i>For the three months ended September 30, 2010</i>				
Revenue	\$ 2,512,100	\$ 1,900,717	\$ –	\$ 4,412,817
Elimination of inter-segment revenue	(51,476)	(22,250)	–	(73,726)
Total revenue	2,460,624	1,878,467	–	4,339,091
Gross margin	417,693	530,671	–	948,364
Operating expenses	1,002,248	263,842	257,356	1,523,446
Other items	29,136	20,284	–	49,420
Income tax expense (recovery)	–	2,316	–	2,316
Net income (loss) after taxes	\$ (613,691)	\$ 244,229	\$ (257,356)	\$ (626,818)

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12. OPERATING SEGMENTS (CONTINUED)

	Canadian Operations	U.S. Operations	Corporate	Consolidated Total
AS AT SEPTEMBER 30, 2011				
Assets				
Current assets	\$ 3,058,849	\$ 2,058,667	\$ 1,304,998	\$ 6,422,514
Property and equipment	361,070	303,251	–	664,321
Intangible assets	89,784	1,092,668	–	1,182,452
	\$ 3,509,703	\$ 3,454,586	\$ 1,304,998	\$ 8,269,287

	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	394,750	238,449	–	633,199
Intangible assets	–	1,043,987	–	1,043,987
	\$ 2,603,880	\$ 3,062,802	\$ 3,009,431	\$ 8,676,113

Revenue for the three months ended September 30,	2011		2010
Canada	\$ 1,647,915	\$	2,424,748
United States	1,704,108		1,677,617
International	134,039		236,726
	\$ 3,486,062	\$	4,339,091

Included in sales for the three months ended September 30, 2011, were sales of \$0.9 million to the Canadian Federal Government which represents 24.8% 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.

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13. FINANCE INCOME AND FINANCE COSTS

Recognized in profit or loss:

<i>For the three months ended September 30,</i>	2011	2010
Interest income on bank deposits	\$ 3,216	\$ –
Finance income	\$ 3,216	\$ –
Interest on bank indebtedness	\$ 9,192	\$ 54,207
Interest on long-term debt	15,010	14,397
Interest on convertible debentures	24,999	12,169
Accretion of convertible debentures	23,359	10,297
Finance costs	\$ 72,560	\$ 91,070

14. LOSS PER SHARE

As the Company incurred a net loss during the three months ended September 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:

	As at September 30, 2011
Shares issuable on conversion of convertible debentures	10,000,000
Stock options	4,875,000
	14,875,000

15. RELATED PARTY TRANSACTIONS

Consulting expenses for services performed by a shareholder and director of the Company during the three months ended September 30, 2011 were \$30,000 (three months ended September 30, 2010 - \$Nil). These expenses are included in general and administrative expenses.

16. EXPLANATION OF TRANSITION TO IFRS

As stated in Note 2(a), these are the Company's first consolidated interim financial statements prepared in accordance with IAS 34 *Interim Financial Reporting*.

The accounting policies set out in note 3 have been applied in preparing the condensed consolidated interim financial statements for the three months ended September 30, 2011, the comparative information for the three months ended September 30, 2010 and year ended June 30, 2011, and the opening IFRS statement of financial position at July 1, 2010.

In preparing its opening IFRS statement of financial position, the Company has adjusted certain amounts reported previously in its financial statements prepared in accordance with previous Canadian GAAP. An explanation of how the transition from previous Canadian GAAP to IFRS has affected the Company's financial position, financial performance and cash flows is set out in the following tables and the notes that accompany the tables.

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16. EXPLANATION OF TRANSITION TO IFRS (CONTINUED)

Reconciliation of equity

July 1, 2010	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
ASSETS				
CURRENT ASSETS				
Cash and cash equivalents		\$ —	\$ —	\$ —
Accounts receivable		4,154,435	—	4,154,435
Inventories		2,258,874	—	2,258,874
Prepaid expenses and deposit		204,677	—	204,677
Investment tax credits and recoverable		40,000	—	40,000
Assets held for sale		250,215	—	250,215
		6,908,201	—	6,908,201
NON-CURRENT ASSETS				
Property and equipment	a, b	1,426,667	(538,897)	887,770
Intangible assets	b, c, e	3,805,750	(17,602)	3,788,148
		5,232,417	(556,499)	4,675,918
TOTAL ASSETS		\$ 12,140,618	\$ (556,499)	\$ 11,584,119
LIABILITIES AND EQUITY				
CURRENT LIABILITIES				
Bank indebtedness		\$ 2,410,390	\$ —	\$ 2,410,390
Accounts payable and accrued liabilities	f	3,841,698	(148,911)	3,692,787
Provisions	f	—	148,911	148,911
Deferred revenue		93,089	—	93,089
Income taxes payable		—	—	—
Current portion of long-term debt		214,320	—	214,320
		6,559,497	—	6,559,497
NON-CURRENT LIABILITIES				
Long-term debt		946,580	—	946,580
Convertible debentures		—	—	—
		946,580	—	946,580
TOTAL LIABILITIES		7,506,077	—	7,506,077
EQUITY				
Share capital		17,614,731	—	17,614,731
Warrants		—	—	—
Contributed surplus		1,194,176	—	1,194,176
Other paid-in capital		—	—	—
Deficit	g	(14,174,366)	(556,499)	(14,730,865)
Accumulated other comprehensive income		—	—	—
		4,634,541	(556,499)	4,078,042
TOTAL LIABILITIES AND EQUITY		\$ 12,140,618	\$ (556,499)	\$ 11,584,119

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16. EXPLANATION OF TRANSITION TO IFRS (CONTINUED)

Reconciliation of equity (continued)

September 30, 2010	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
ASSETS				
CURRENT ASSETS				
Cash and cash equivalents		\$ —	\$ —	\$ —
Accounts receivable		3,151,651	—	3,151,651
Inventories		2,247,579	—	2,247,579
Prepaid expenses and deposit		313,524	—	313,524
Investment tax credits and recoverable		40,000	—	40,000
Assets held for sale		—	—	—
		5,752,754	—	5,752,754
NON-CURRENT ASSETS				
Property and equipment	a, b, e	1,341,505	(524,730)	816,775
Intangible assets	b, c, e	3,816,201	(66,116)	3,750,085
		5,157,706	(590,846)	4,566,860
TOTAL ASSETS		\$ 10,910,460	\$ (590,846)	\$ 10,319,614
LIABILITIES AND EQUITY				
CURRENT LIABILITIES				
Bank indebtedness		\$ 1,604,292	\$ —	\$ 1,604,292
Accounts payable and accrued liabilities	f	3,275,214	(92,352)	3,182,862
Provisions	f	—	92,352	92,352
Deferred revenue		30,520	—	30,520
Income taxes payable		—	—	—
Current portion of long-term debt		142,880	—	142,880
		5,052,906	—	5,052,906
NON-CURRENT LIABILITIES				
Long-term debt		1,000,160	—	1,000,160
Convertible debentures	d	651,949	14,457	666,406
		1,652,109	14,457	1,666,566
TOTAL LIABILITIES		6,705,015	14,457	6,719,472
EQUITY				
Share capital		17,614,731	—	17,614,731
Warrants		45,500	—	45,500
Contributed surplus		1,194,176	—	1,194,176
Other paid-in capital	d	290,980	(56,027)	234,953
Deficit	g	(14,939,942)	(417,742)	(15,357,684)
Accumulated other comprehensive income	e	—	(131,534)	(131,534)
		4,205,445	(605,303)	3,600,142
TOTAL LIABILITIES AND EQUITY		\$ 10,910,460	\$ (590,846)	\$ 10,319,614

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16. EXPLANATION OF TRANSITION TO IFRS (CONTINUED)

Reconciliation of equity (continued)

June 30, 2011	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
ASSETS				
CURRENT ASSETS				
Cash and cash equivalents		\$ 2,897,735	\$ –	\$ 2,897,735
Accounts receivable		2,431,490	–	2,431,490
Inventories		1,349,006	–	1,349,006
Prepaid expenses and deposit		279,560	–	279,560
Investment tax credits and recoverable		41,136	–	41,136
Assets held for sale		–	–	–
		6,998,927	–	6,998,927
NON-CURRENT ASSETS				
Property and equipment	a, b, e	1,095,910	(462,711)	633,199
Intangible assets	b, c, e	2,231,661	(1,187,674)	1,043,987
		3,327,571	(1,650,385)	1,677,186
TOTAL ASSETS		\$ 10,326,498	\$ (1,650,385)	\$ 8,676,113
LIABILITIES AND EQUITY				
CURRENT LIABILITIES				
Bank indebtedness		\$ 693,026	\$ –	\$ 693,026
Accounts payable and accrued liabilities	f	3,044,535	(721,398)	2,323,137
Provisions	f	–	721,398	721,398
Deferred revenue		73,134	–	73,134
Income taxes payable		105,038	–	105,038
Current portion of long-term debt		214,320	–	214,320
		4,130,053	–	4,130,053
NON-CURRENT LIABILITIES				
Long-term debt		839,420	–	839,420
Convertible debentures	d	728,653	13,843	742,496
		1,568,073	13,843	1,581,916
TOTAL LIABILITIES		5,698,126	13,843	5,711,969
EQUITY				
Share capital		20,080,222	–	20,080,222
Warrants		45,500	–	45,500
Contributed surplus		1,768,027	–	1,768,027
Other paid-in capital	d	290,980	(56,027)	234,953
Deficit	g	(17,556,357)	(1,240,388)	(18,796,745)
Accumulated other comprehensive income	e	–	(367,813)	(367,813)
		4,628,372	(1,664,228)	2,964,144
TOTAL LIABILITIES AND EQUITY		\$ 10,326,498	\$ (1,650,385)	\$ 8,676,113

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16. EXPLANATION OF TRANSITION TO IFRS (CONTINUED)

Reconciliation of comprehensive income

Three months ended September 30, 2010	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
SALES		\$ 4,339,091	\$ –	\$ 4,339,091
COST OF SALES	a	3,389,698	1,029	3,390,727
GROSS MARGIN		949,393	(1,029)	948,364
OPERATING EXPENSES				
Sales and marketing	b	586,684	81,088	667,772
Research and development	b	70,339	48,297	118,636
General and administration	b, d	765,470	(28,432)	737,038
Depreciation of property and equipment	a, b	38,277	(38,277)	–
Amortization of intangible assets	b, c	122,357	(122,357)	–
Total operating expenses		1,583,127	(59,681)	1,523,446
LOSS BEFORE OTHER ITEMS		(633,734)	58,652	(575,082)
OTHER ITEMS				
Foreign exchange loss (gain)	e	14,193	(78,582)	(64,389)
Finance income		–	–	–
Finance costs	d	92,594	(1,524)	91,070
Loss on sale of assets		22,739	–	22,739
Total other items		129,526	(80,106)	49,420
LOSS BEFORE INCOME TAXES		(763,260)	138,758	(624,502)
INCOME TAXES				
Current income tax expense		2,316	–	2,316
Deferred income tax expense		–	–	–
Total income tax expense		2,316	–	2,316
NET LOSS FOR THE PERIOD		(765,576)	138,758	(626,818)
OTHER COMPREHENSIVE INCOME (LOSS)				
Foreign currency translation differences – foreign operations	e	–	(131,534)	(131,534)
TOTAL COMPREHENSIVE LOSS FOR THE PERIOD		\$ (765,576)	\$ 7,224	\$ (758,352)

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16. EXPLANATION OF TRANSITION TO IFRS (CONTINUED)

Reconciliation of comprehensive income (continued)

Year ended June 30, 2011	Note	Canadian GAAP	Effect of transition to IFRS	IFRS
SALES		\$ 22,663,696	\$ –	\$ 22,663,696
COST OF SALES	a	17,670,900	4,400	17,675,300
GROSS MARGIN		4,992,796	(4,400)	4,988,396
OPERATING EXPENSES				
Sales and marketing	b	2,027,148	319,071	2,346,219
Research and development	b	315,396	316,904	632,300
General and administration	b, d	3,367,017	17,039	3,384,056
Depreciation of property and equipment	a, b	154,089	(154,089)	–
Amortization of intangible assets	b, c	607,085	(607,085)	–
Total operating expenses		6,470,735	(108,160)	6,362,575
LOSS BEFORE OTHER ITEMS		(1,477,939)	103,760	(1,374,179)
OTHER ITEMS				
Foreign exchange loss (gain)	e	7,671	(242,035)	(234,364)
Finance income		(26,808)	–	(26,808)
Finance costs	d	379,367	(12,160)	367,207
Long-lived asset impairment	c	–	1,096,000	1,096,000
Loss on sale of assets	c	1,543,822	(54,156)	1,489,666
Total other items		1,904,052	787,649	2,691,701
LOSS BEFORE INCOME TAXES		(3,381,991)	(683,889)	(4,065,880)
INCOME TAXES				
Current income tax expense		–	–	–
Deferred income tax expense		–	–	–
Total income tax expense		–	–	–
NET LOSS FOR THE YEAR		(3,381,991)	(683,889)	(4,065,880)
OTHER COMPREHENSIVE INCOME (LOSS)				
Foreign currency translation differences – foreign operations	e	–	(367,813)	(367,813)
TOTAL COMPREHENSIVE LOSS FOR THE YEAR		\$ (3,381,991)	\$ (1,051,702)	\$ (4,433,693)

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16. EXPLANATION OF TRANSITION TO IFRS (CONTINUED)

Reconciliation of cash flows

There are no material differences between the statement of cash flows presented under IFRS and the statement of cash flows presented under previous Canadian GAAP.

Notes to the reconciliations

(a) Property and equipment

The Company elected under IFRS 1 *First-time adoption of IFRS*, to measure certain items of property and equipment at fair value and to deem the fair value as the new carrying cost as of July 1, 2010. Fair value was determined by a third party certified asset appraiser.

The impact arising from changes to property and equipment are summarized as follows:

	July 1, 2010	June 30, 2011
Consolidated statement of financial position:		
Reduction in property and equipment to fair value	\$ (323,894)	\$ (323,894)
Impairment – costs to sell (c)	(53,500)	(53,500)
Depreciation adjustments	–	102,626
Reclassification of software to intangible assets	(161,503)	(161,503)
Effect of movements in exchange rates (e)	–	(26,440)
Adjustments to Property and equipment	\$ (538,897)	\$ (462,711)

(b) Depreciation and amortization expenses

Under IFRS the Company has adopted classification of expenses by function in the Statement of Comprehensive Income. Depreciation and amortization expenses have been reclassified to the appropriate functional classification.

(c) Intangible assets

The Company assessed the recoverable amount of its CGUs at July 1, 2010 on transition to IFRS. The recoverable amount was based on a value in use calculation. Under Canadian GAAP, the recoverable amount was calculated on an undiscounted basis, using higher long-term growth assumptions than are permissible under IFRS, and no impairment was recognized.

Impairment testing was performed as at July 1, 2010 in accordance with IFRS, based on a value in use calculation.

Value in use was based on cash flows expected to be generated from each of the Company's two CGUs. Cash flows were projected up to the date that the assets within the CGUs are expected to be consumed by the entity. For the Canada CGU the expected life was 7 years and the life of the USA CGU was 7 years. The key assumptions used in the value in use calculations of the CGUs are:

- Expected life of the CGUs' assets
- Projection of cash inflows and outflows
- Discount rates

The value in use was determined using pre-tax discount rates of 31.98% and 25.04% for Canada and the USA CGUs, respectively. Cash flows were projected based on past experience, actual operating results and the Company's operating plan extrapolated for a 5 year period. A zero growth rate was assumed beyond year 5.

Based on the value in use assessment, the carrying amount of the Canada CGU was determined to be \$164,020 higher than its recoverable amount and an impairment loss was recognized. The impairment loss was allocated to property and

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equipment (\$53,500) and pro rata to the intangible assets (\$110,520) comprising the Canada CGU.

As described in note 6, in accordance with IFRS, the Company recognized a further impairment loss with respect to the Canada CGU at June 30, 2011 in the amount of \$1,096,000.

The impact arising from changes to intangible assets is summarized as follows:

	July 1, 2010	June 30, 2011
Consolidated statement of financial position:		
Reclassification of software	\$ 161,503	\$ 161,503
Impairment loss	(110,520)	(1,206,520)
Amortization adjustments	-	(28,890)
Disposal adjustment	-	54,156
Effect of movements in exchange rates (e)	(68,585)	(167,923)
Adjustments to Intangible assets	\$ (17,602)	\$ (1,187,674)

(d) Convertible debentures

In accordance with IFRS the Company has restated the allocation of the proceeds assigned to the debt and equity components on the issuance of convertible debentures on August 17, 2010. Under Canadian GAAP, the proceeds were allocated based on the relative fair values. Under IFRS, the proceeds assigned to the debt and conversion option are allocated based on the fair value of the Debentures with the residual being allocated to the Conversion Option.

Under IFRS, directly attributable transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts. Under Canadian GAAP the Company had elected a policy to expense Debenture transaction costs as incurred.

The impact arising from these changes is summarized below:

	Three months ended September 30, 2010	Year ended June 30, 2011
Consolidated statement of comprehensive income:		
Capitalization of debenture issue costs	\$ (40,046)	\$ (30,024)
Decrease in accretion of convertible debentures	(1,524)	(12,160)
Adjustment to Net loss	\$ (41,570)	\$ (42,184)

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	July 1, 2010	June 30, 2011
Consolidated statement of financial position:		
Decrease in Other paid-in capital conversion option	\$ –	\$ 56,027
Adjustment to allocation of proceeds	\$ –	\$ (56,027)
Transaction costs capitalized	–	30,024
Decrease in accretion expense	–	12,160
Increase in Convertible debentures	\$ –	\$ (13,843)

(e) Foreign currency translation – foreign operations

Under IFRS the Company has determined that the functional currency of the U.S. operating subsidiary, Sentry Armor Systems Inc., is the U.S. dollar. Sales prices, labour and material costs of the U.S. operating subsidiary are determined in U.S. dollars which are primary indicators of the functional currency in accordance with IFRS. Under Canadian GAAP, the U.S. operating subsidiary was accounted for as an integrated foreign operation. The U.S. operating subsidiary is generating positive cash flows in U.S. dollars and is no longer dependent on funding from the Canadian parent company.

The Company elected, under IFRS 1 *First-time adoption of IFRS*, to deem all foreign currency translation differences that arose prior to the date of transition to be nil at the date of transition. As a result foreign currency translation differences in the amount of \$68,585 were reclassified to Deficit on July 1, 2010.

Cumulative foreign currency translation differences with respect to the U.S. operating subsidiary were \$(131,534) and \$(367,813) at September 30, 2010 and June 30, 2011, respectively, resulting in a reduction to foreign exchange losses recorded under Canadian GAAP. Under IFRS foreign currency translation differences are recorded in other comprehensive income.

(f) Provisions

Provisions for warranties, restructuring costs and onerous contracts were reclassified to Provisions under IFRS. They were previously classified as Accounts payable and accrued liabilities under Canadian GAAP.

(g) Deficit

The above adjustments to Deficit for differences between IFRS and Canadian GAAP can be summarized as follows:

	July 1, 2010	September 30, 2010	June 30, 2011
Property and equipment, fair value adjustment (a)	\$ 323,894	\$ 323,894	\$ 323,894
Impairment (a) (c)	164,020	164,020	1,260,020
Depreciation and amortization (a) (c)	–	(18,605)	(73,736)
Loss on sale of assets (c)	–	–	(54,156)
Debenture transaction costs (d)	–	(40,046)	(30,024)
Debenture accretion (d)	–	(1,524)	(12,160)
Foreign exchange losses (e)	–	(131,534)	(367,813)
Effect of movements in exchange rates (a) (c) (e)	68,585	121,537	194,363
TOTAL ADJUSTMENTS	\$ 556,499	\$ 417,742	\$ 1,240,388