Pacific Safety Products Inc.

REPORT TO SHAREHOLDERS

MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE YEARS ENDED JUNE 30, 2016 and 2015

Management's Discussion and Analysis

June 30, 2016 and 2015

This Management's Discussion and Analysis ("MD&A") of the financial position and financial performance of Pacific Safety Products Inc. (the "Company" or "PSP") has been prepared as of September 28, 2016 and should be read together with the audited annual consolidated financial statements and the notes thereto for the year ended June 31, 2016. 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 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 resizing plans, acquisitions, divestitures and alliances, cost of raw material, the uncertainty associated with the outcome of research and development of new products, including regulatory approval and market acceptance, and seasonality of sales in some products, as well as other factors described below under "Part VIII: Risks and Uncertainties" and the Company's other filings with applicable securities regulatory authorities which are available at www.sedar.com. The impact of any one risk factor on a particular forward-looking statement is not determinable with certainty as such factors are interdependent upon other factors, and management's course of action would depend upon its assessment of the future, considering all information then available.

Although the Company believes that the expectations and assumptions conveyed by the forward-looking information are reasonable based on information available to it as of September 28, 2016, 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 Polices 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 and sale 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 GH Armor Systems Inc. ("GH"), provides body armour products to U.S. based law enforcement and private security firms. The Company's business strategy is to be a preferred supplier of body armour and other personal protection solutions throughout North America.

PSP has a significant recurring revenue stream from its Canadian customers in the form of long standing contracts with terms of up to five years. These contracts are with federal, provincial and municipal organizations and agencies. The Company also pursues long- term defence contracts. PSP has been successful in supplying the Canadian military with fragmentation protection products and chemical and biological protection suits. The Company's U.S. business is primarily supplying state, county and municipal law enforcement agencies with soft body armour. These products are sold primarily through a network of third party distributors.

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

PSP has manufacturing operations in Arnprior, Ontario and Dover, Tennessee and its head office is located in Arnprior, Ontario. Its design and production facilities are all ISO9001:2008 registered and compliant to BA9000 (National Institute of Justice Body Armor Quality Management Requirements). Founded in 1984, PSP currently employs 129 employees at its Canadian and U.S. facilities.

Recent Events

On June 29, 2016 PSP was award a contract from a Canadian federal agency valued at up to $33m over a period of 10 years.

On May 23, 2016 PSP paid off their long-term debt with Business Development Bank of Canada.

On February 9, 2016 the Credit Agreement with a Canadian bank (the "Bank") for a credit facility was increased to the amount of $1.55 million from $0.9 million. Along with the increased credit facility, the bank is providing a hedging opportunity for forward purchases of foreign currency and a revolving lease line for capital equipment in the amount of $0.5 million. Our lending rate has also been reduced from the bank prime lending rate plus 1.95% per annum to the bank prime lending rate plus 1.10% per annum.

On June 30, 2015 its Arnprior Landlord, Arnprior Bay Properties Limited signed a Minutes of Settlement to resolve the ongoing lease arbitration initially announced by PSP on June 3, 2013. PSP will see a total recovery of $825,000, inclusive of the interim award PSP has already received and significant legal fees paid during the arbitration process. PSP will also enter into a new 5 year lease with the landlord under similar terms to our existing lease, expiring in 2021.

The company has taken the necessary steps to align and size its operations to current North American business, while maintaining the ability to respond to new North American and international opportunities as they arise. The Company continues to focus on adding value for its customers in conjunction with revenue stability and growth.

Strategic Review Process

The Board and management of the Company have historically evaluated, from time to time, strategic alternatives available to the Company for the purpose of enhancing shareholder value. Having stabilized the Company from an operational perspective over the last two years and with the Company returning to profitability in 2015, the Board determined that shareholder value may also be enhanced by engaging in a strategic review process. Accordingly, in 2015 the Board retained ZED Financial to act as its financial advisor to assist the Company in exploring and pursuing potential value-enhancing transactions.

While the company has considered and pursued various potential alternatives, it has not entered into a binding agreement in respect of any specific transactions and the strategic review process remains ongoing on multiple fronts and at various levels. As a result of this process, PSP has expensed approximately $200,000 in financial advisory, legal and other fees and expenses incurred to date in connection with the strategic review process. PSP categorizes the majority of these expenses as one-time as they are not likely to be repeated. However, the company may incur additional expenses, albeit expected to be at a much smaller cost to the company, as it continues to explore how it may further enhance shareholder value.

Shareholders are cautioned that there is no defined timeline for the strategic review process and there can be no assurance that any specific transaction will be completed either in the near future or at all. The company does not intend to comment further regarding the strategic review process or the evaluation of strategic options, unless a bind agreement is concluded or it otherwise deems further disclosure is required by applicable law.

Part ll: RESULTS

SUMMARY OF OPERATIONS		**YEAR ENDED JUNE 30, 2016**		YEAR ENDED JUNE 30, 2015
REVENUES	**$**	**20,149,441**	$	17,728,855
COST OF SALES		**15,183,293**		12,599,904
GROSS PROFIT		**4,966,148**		5,128,951
EXPENSES		**4,444,140**		3,781,854
INCOME BEFORE OTHER ITEMS		**522,008**		1,347,097
OTHER ITEMS		**(2,613)**		330,165
INCOME BEFORE INCOME TAXES		**524,621**		1,016,932
INCOME TAXES		**—**		—
FUTURE INCOME TAX RECOVERY		**(1,592,000)**		—
NET INCOME FOR THE PERIOD	**$**	**2,116,621**	$	1,016,932
OTHER COMPREHENSIVE INCOME (LOSS)		**(49,421)**		123,137
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		**2,067,200**		1,140,069
INCOME PER SHARE -				
BASIC	**$**	**0.03**	$	0.02
DILLUTED	**$**	**0.03**	$	0.01

ADJUSTED EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTIZATION ("ADJUSTED EBITDA")

		YEAR ENDED JUNE 30, 2016		YEAR ENDED JUNE 30, 2015
NET INCOME FOR THE PERIOD BEFORE TAX	**$**	**524,621**	$	1,016,932
FINANCE COSTS, NET		**96,658**		177,833
DEPRECIATION AND AMORTIZATION		**158,489**		147,672
EBITDA	**$**	**779,768**	$	1,342,437
FOREIGN EXCHANGE (GAIN)		**(99,271)**		147,674
SHARE BASED COMPENSATION		**-**		5,000
ADJUSTED EBITDA	**$**	**680,497**	$	1,495,111

FINANCIAL POSITION		**AS AT JUNE 30, 2016**		AS AT JUNE 30, 2015
TOTAL ASSETS	**$**	**7,772,106**	$	5,889,585
TOTAL LONG-TERM FINANCIAL LIABILITIES	**$**	**770,978**	$	756,462

Revenue

Revenues for the year ended June 30, 2016 were $20.1 million, an increase of $2.4 million or 13.7% as compared with the same period in the prior year. Revenues from Canadian customers for the year ended June 30, 2016 were $10.5 million, a decrease of $0.9 million or 7.5% compared to the same period in the prior year. The decrease relate to the timing of orders for key contracts from the likes of CBSA, Corrections, and other Federal and provincial agencies. Revenues from U.S. and International customers for the year ended June 30, 2016 were $9.6 million, an increase of $3.3 million or 51.7% compared to the same period in the prior year. The increase in U.S. sales relates primarily to new products and developing our brand, and increasing our foot print through distributors and new customers.

Gross Margin

For the year ended June 30, 2016, gross margin as a percentage of revenues was 24.6%, a decrease of 4.3% compared with the same period in the prior year. The decrease relates primarily to one time adjustment in the prior year from a lease award settlement.

Expenses

For the year ended June 30, 2016, expenses were $4.4 million an increase of $0.7 million compared to the same period in the prior year. The increase in expenses related to increased sales and marketing cost developing the US market and a one time adjustment to G&A in the prior year from a lease award settlement.

For the year ended June 30, 2016, sales and marketing expenses were $1.8 million, as compared to $1.5 million for the same period in the prior year.

For the year ended June 30, 2016, research and development expenses were $0.8 million unchanged compared to same period in the prior year.

For the year ended June 30, 2016, general and administration expenses were $1.8 million an increase of $0.3 million compared to the same period in the prior year. The increase is primarily related to cost for strategic initiatives compared to the same period in the prior year.

Foreign exchange losses (gains)

For the year ended June 30, 2016, foreign exchange gain was $0.1 million as compared to a loss of $0.1 million during the same period in the prior year. The gain is primarily related to the impact of fluctuations in of the Canadian dollar against the U.S. dollar with respect to purchases of materials in U.S. funds.

Finance costs

For the year ended June 30, 2016, finance costs were $0.1 million as compared to $0.2 million for the same period in the prior year. The decrease is from the paying down of debt.

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. No income taxes were paid in the past two years. As at June 30, 2016 PSP recognized $1.6 million as future income taxes recoverable supported by consistently reporting taxable income for the past 3 years with the probability of PSP producing taxable income into the future.

Net income for the year

For the year ended June 30, 2016, the Company recorded a net income of $2.1 million an increase of $1.1 million compared to a net income of $1.0 million in the prior year. The one time adjustment in the prior year of $0.8 million was offset by additional earnings in the year of $0.5 million from increased sales and the recognition of future income tax recoverable.

Other comprehensive income (loss)

For the year ended June 30, 2016, the Company recorded other comprehensive loss of $0.05 million compared to an income of $0.1 million during the prior year. Other comprehensive income arises from foreign currency translation differences and fluctuates with the strength of the Canadian currency relative to the U.S.

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

Adjusted EBITDA is not a recognized performance measure under IFRS and does not have a standardized meaning prescribed by IFRS. The term Adjusted EBITDA consists of net loss and excludes interest, income tax expense (recovery), depreciation and amortization. Adjusted EBITDA excludes share-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 non-recurring. The most directly comparable measure to Adjusted EBITDA calculated in accordance with IFRS is net income for the year.

For the year ended June 30, 2016 Adjusted EBITDA was $0.7 million, a decrease of $0.8 million or 54.5% as compared to an Adjusted EBITDA of $1.5 million during the same period in the prior year (which increased of $1.1 million or 340.5% over 2014).

Part III: CASH FLOW

CASH PROVIDED BY (USED IN)		***YEAR ENDED JUNE 30, 2016***		*YEAR ENDED JUNE 30, 2015*
Operating activities	**$**	**903,703**	$	(544,396)
Investing activities		**(115,144)**		(92,486)
Financing activities		**(320,710)**		32,179
Increase (decrease) in cash and cash equivalents, net of bank overdraft used for cash management purposes	**$**	**467,889**	$	(604,703)

Cash flow from operating activities for the year ended June 30, 2016 was $0.9 million as compared to $0.5 million used during the same period in the prior year. The increase is due to earnings generating net positive cash flow.

Cash flow used in investing activities for the year ended June 30, 2016 was $0.1 million as compared to $0.1 million during the same period in the prior year.

Cash flow used in financing activities for the year ended June 30, 2016 relates to the repayment of the operating line of credit and the repayment of long term debt was $0.3 million as compared to the prior year when we were able to release the $1.0 million GIC by the bank, which was no longer required to be held as collateral. This was offset by the net $0.2 million outflow for the repayment and issuance of debentures, $0.6 million repayment of the overdraft facility and $0.2 million repayment of long-term debt.

Part IV: LIQUIDITY AND CAPITAL RESOURCES

AS AT		***JUNE 30, 2016***		*JUNE 30, 2015*
Cash and cash equivalents	**$**	**600,052**	$	128,255
Bank indebtedness		**-**		(160,000)
Working capital		**4,004,878**		3,421,418
Convertible debentures		**(711,504)**		(693,157)
Shareholders' equity		**(5,188,314)**		(3,085,364)

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. During 2016, the Company was successful in negotiating a new Line of Credit agreement with the Bank with more favourable terms and the Company now has access to a $1.6 million credit facility.

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, raising additional equity, working closely with our financial institution to obtain favourable borrowing terms and other value enhancing opportunities. The Company receives continued support from its bank and lender.

Working Capital

As at June 30, 2016, PSP's working capital was $4.0 million compared to $3.4 million as at June 30, 2015. The working capital reflects an increase in trade and other receivables of $0.2 million, a decrease in inventory of $0.3 million, an increase in trade and other payables of $0.2 million a decrease in current portion of long term debt of $0.2 million and a net increase in cash and cash equivalents of $0.3 million.

Accounts receivable as at June 30, 2016 were $3.6 million compared to $3.4 million as at June 30, 2015. The increase in accounts receivable reflects the increase in revenues in the three months ended June 30, 2016 compared to the three months ended June 31, 2015 and the timing of collection of those revenues.

Inventory as at June 30, 2016 decreased by $0.3 million to $1.5 million as compared to $1.8 million as at June 30, 2015. This decrease is primarily related to an increased in sales from new contracts at the end of the period.

Accounts payable and accrued liabilities as at June 30, 2016 decreased $0.2 million to $1.8 million as compared to $2.0 million as at June 30, 2015. This reflects the timing in inventory and production volumes, stable expenses, and the timing of payments.

Bank Indebtedness

PSP has a Credit Agreement with a Canadian bank (the "Bank") for a credit facility in the amount of $1,550,000. The facility is a revolving demand facility available by way of overdraft with interest payable monthly calculated at the bank prime lending rate plus 1.10% per annum. The facility is secured by a general security agreement constituting a first ranking security interest over all personal property of PSP and its subsidiaries. The Agreement has a financial covenant, a ratio of Total Liabilities to Tangible Net Worth of not greater than 1.5:1 and a Debt Service Coverage ratio of not less than 1.25:1. At June 30, 2016 and June 30, 2015, the amounts drawn on the credit facility were Nil and $160,000 respectively. As at June 30, 2016 PSP is in compliance with the covenant.

Long-term Debt

The Company had a secured term loan with the Business Development Bank of Canada ("BDC" or the "Lender"). At June 30, 2016, the principal outstanding on the loan was Nil.

Convertible debentures

On February 17, 2015 the Company issued $749,000 of unsecured convertible debentures (the "Convertible Debentures") with the following terms: (i) interest payable annually at a rate of 10% in cash or common shares, at the option of the Company; (ii) 3 year term, with a maturity date of February 18, 2018, with early repayment possible, at the option of the Company, after 1 year from date of issuance; (iii) convertible into common shares of the Company at the option of the holder at a rate of one common share per $0.15 of indebtedness. Interest expense is based on the effective interest method, with accretion expense of $8,949 recorded for the twelve months ended June 30, 2016.

Certain officers and directors of the Company beneficially own or control, directly or indirectly $516,500 aggregate principal amount of the Convertible Debentures (June 30, 2015 - $516,500 of the Debentures).

Deferred Income Taxes

As at June 30, 2016, the Company has cumulative non-capital losses available to be carried forward in the following jurisdictions: Canada – $3,770,000 and United States – $7,971,000. The non-capital losses in Canada begin to expire in 2030. The net operating losses in the U.S. begin to expire in 2027. The Company also has net capital losses in Canada of $4,372,000, which do not have an expire date.

As at June 30, 2016, the Company has Federal investment tax credits of $1,209,000 (2015 – 1,201,000) available to reduce future Federal Canadian income taxes payable. The investment tax credits begin to expire in 2027.

In addition, the Company has Ontario research and development tax credits of $31,000 which are available to reduce future Ontario income taxes payable. The credits begin to expire in 2036.

The Scientific Research and Experimental Development expenditures of $3,522,000 can be carried forward indefinitely.

The deferred tax benefits relating to the tax assets in the U.S. have not been recognized in the consolidated financial statements as the recognition requirements under the liability method of accounting for income taxes have not been met.

A portion of the deferred tax benefits relating to the tax assets in Canada have been recognized in the consolidated financial statements as it is probable that's taxable profits will be available against which $1,592,000 [2015-nil] of deferred tax assets can be utilized. The balance of the Canadian deferred tax benefits remain unrecognized.

Capital and Other Components of Equity

At June 30, 2016 the Company's issued and outstanding shares were 66,403,189 compared to 65,928,189 at June 31, 2015.

On September 4, 2015 the Company issued 75,000 common shares to a former employee of the Company upon exercise of 75,000 stock options with an exercise price of $0.11.

On September 14, 2015 the Company issued 50,000 common shares to an employee of the Company upon exercise of 50,000 stock options with an exercise price of $0.11.

On October 2, 2015 the Company issued 150,000 common shares to an employee of the Company upon exercise of 150,000 stock options with an exercise price of $0.05.

On October 21, 2015 the Company issued 25,000 common shares to an employee of the Company upon exercise of 25,000 stock options with an exercise price of $0.11.

On November 6, 2015 the Company issued 125,000 common shares to an employee of the Company upon exercise of 125,000 stock options with an exercise price of $0.05.

On December 15, 2015 the Company issued 50,000 common shares to an employee of the Company upon exercise of 50,000 stock options with an exercise price of $0.11.

The Company's contributed surplus balance was $2.1 million at June 30, 2016, unchanged from June 30, 2015.

Other paid-in capital of $0.3 million at June 30, 2016 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 “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 “Debentures”.

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

Part V: QUARTERLY RESULTS

Fiscal 2016	**June 30, 2016**	**March 31. 2016**	**December 31, 2015**	**September 30, 2015**
Revenues	**$ 5,556,662**	**$ 5,233,746**	**$ 4,410,979**	**$ 4,948,054**
Net income for the period	**1,834,002**	**4,330**	**10,952**	**267,327**
Basic and diluted earnings per share	**0.03**	**-**	**-**	**-**
Fiscal 2015	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014
Revenues	$ 5,477,187	$ 5,003,565	$ 3,515,938	$ 3,732,165
Net income (loss) for the period	986,481	78,995	(171,556)	37,521
Basic and diluted earnings (loss) per share	.02	-	-	-
Fiscal 2014	June 30, 2014	March 31, 2014	December 31, 2013	September 30, 2013
Revenues	$ 3,850,825	$ 3,660,247	$ 2,976,357	$ 3,854,785
Net income (loss) for the period	95,965	51,244	(496,555)	176,801
Basic and diluted earnings (loss) per share	-	-	(0.01)	-

Significant Fluctuations in Quarterly Results

For the three months ended June 30, 2016, the Company recorded net income from operations of $1.8 million. The increase in income compared to the prior quarter was due to increase sales and the mix of product sold plus the recognition of Future income taxes recoverable.

For the three months ended March 31, 2016, the Company recorded net income from operations of $0.004 million. The increase in income compared to the prior quarter was offset by exchange loss.

For the three months ended December 31, 2015, the Company recorded net income from operations of $0.01 million. The decrease in income compared to the prior quarter is primarily due to the reduction in sales and margins.

For the three months ended September 30, 2015, the Company recorded net income from operations of $0.3 million. The decrease in income compared to the prior quarter is primarily due to higher R&D costs for certifications of new products and unfavourable exchange rates for the three months ended September 30, 2015.

For the three months ended June 30, 2015, the Company recorded net income from operations of $1.0 million. The increase in income compared to the prior quarter is due to higher volumes generating higher gross margins and the settlement of the landlord arbitration of $0.8 million which was partially recognized in prior quarters.

Part VI: SIGNIFIANT ACCOUNTING POLICES AND ESTIMATES

The company's accounting policies are provided in note 3 to the consolidated financial statements for the year ended June 31, 2016.

Use of estimates and judgments

The preparation of the consolidated 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 estimates and judgments, which have the most significant effect on the amounts recognized in the consolidated 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.

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.

Trade and other receivables
The Company uses historical trends and performs specific account assessments when determining the allowance for doubtful accounts. These accounting estimates are in respect to the trade and other receivables line on the Company's consolidated statement of financial position. At June 30, 2016, the trade and other receivables line represented 46% of total assets. The estimate of the Company's allowance for doubtful accounts could change from period to period due to the allowance being a function of the balance and composition of accounts receivable. If the future were to adversely differ from management's expectations of allowance for doubtful accounts, the Company could experience an additional bad debt charge in the future.

Inventories
The Company determines its allowance for inventory obsolescence based upon expected inventory turnover, inventory aging and current and future expectations with respect to product offerings. The Company reviews future revenue trends and forecasts, expected inventory requirements and inventory composition necessary to support future revenues. These accounting estimates are with respect to inventory on the Company's consolidated statement of financial position. At June 30, 2016, the inventory line represented 20% of total assets. The estimate for the Company's allowance for inventory obsolescence could change from period to period due to changes in product offerings and consumer acceptance of those products. If the inventory obsolescence was inadequate it would result in a charge to operations expense in the future.

Provisions
The Company estimates provisions for warranties and onerous contracts. A provision will be recognized if the Company has a legal or constructive obligation due to a prior event. Warranties are based on historical trends. Onerous contracts are based on an unavoidable cost in excess of any future benefit. The onerous contract provision is calculated at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing the contract. Details for these provisions can be found in note 11 to the consolidated financial statements. The estimate for the Company's provisions could change from period to period due to changes in historical trends, revenue or the business environment.

Share-based compensation
The Company uses the Black-Scholes option-pricing model to determine the grant date fair value of share-based compensation. The following assumptions are used in the model: dividend yield; expected volatility; risk-free interest rate; expected option life; and fair value. Changes to assumptions used to determine the grant date fair value of share-based compensation awards can affect the amounts

recognized in the consolidated financial statements.

Part VII: RISKS AND UNCERTAINTIES

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

PSP operates in markets subject to government purchasing patterns and large tenders that are at times unpredictable and create fluctuations in the production load throughout the year. Government purchasing is typically tender driven and subject to competitive bidding. These buying patterns create the necessity of being able to quickly increase and decrease production capacity. PSP has addressed this risk by using 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.

Dependence on Key Personnel

The success of the Company’s operations depends on its senior management team and other key employees, as well as their ability to retain and attract skilled and qualified management and employees. The loss of the services of key personnel could have a material adverse effect on the business, financial condition, results of operations or future prospects of the Company.

Defaults under Credit Agreements

The credit facility with the Canadian bank is a demand facility. In the event that the Company was in default under the terms of the agreement, the bank may thereafter demand repayment of all amounts owing under the bank facility and by virtue of the inter- lender agreement, the Lender may also demand repayment.

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

Other Risks

Refer to the Company’s June 30, 2016 consolidated financial statements note 18 for other risks including credit risk, liquidity risk, currency risk, interest rate risk, and fair value of financial instruments.

Consolidated Financial Statements

Pacific Safety Products Inc.

June 30, 2016

INDEPENDENT AUDITORS' REPORT

To the Shareholders' of
Pacific Safety Products Inc.

We have audited the accompanying consolidated financial statements of **Pacific Safety Products Inc.**, which comprise the consolidated statements of financial position as at June 30, 2016 and 2015 and the consolidated statements of income and comprehensive income, changes in equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

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

Auditors' responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of **Pacific Safety Products Inc.** as at June 30, 2016 and 2015 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

Ernst & Young LLP

Ottawa, Canada
September 28, 2016

Chartered Professional Accountants
Licensed Public Accountants

Pacific Safety Products Inc.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

As at June 30

	2016 $	2015 $
ASSETS		
Current		
Cash and cash equivalents *[note 6]*	**600,052**	128,255
Trade and other receivables *[note 7]*	**3,578,842**	3,403,027
Inventories *[note 8]*	**1,542,914**	1,882,442
Prepaid expenses	**95,884**	55,453
Total current assets	**5,817,692**	5,469,177
Deferred tax asset *[note 14]*	**1,592,000**	—
Property and equipment, net *[note 9]*	**329,186**	363,335
Prepaid deposits	**33,228**	57,073
	7,772,106	5,889,585
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Bank indebtedness *[note 6]*	—	160,000
Trade and other payables *[note 10]*	**1,752,757**	1,587,458
Short-term provisions *[note 11]*	**36,578**	31,662
Deferred revenue	**23,479**	72,179
Current portion of long-term debt *[note 12]*	—	196,460
Total current liabilities	**1,812,814**	2,047,759
Long-term provisions *[note 11]*	**59,474**	63,305
Convertible debentures *[note 13]*	**711,504**	693,157
	2,583,792	2,804,221
Shareholders' equity		
Share capital *[note 15]*	**20,590,066**	20,554,316
Contributed surplus *[notes 15 and 17]*	**2,075,652**	2,075,652
Other paid-in capital	**269,563**	269,563
Deficit	**(17,738,243)**	(19,854,864)
Accumulated other comprehensive income (loss)	**(8,724)**	40,697
Total shareholders' equity	**5,188,314**	3,085,364
	7,772,106	5,889,585

Commitments *[note 19]*

See accompanying notes

On behalf of the Board

Terry Vaudry, Director

Fraser Campbell, Chairman of the Board

Pacific Safety Products Inc.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

Year ended June 30

	2016	2015
	$	$
Revenue	**20,149,441**	17,728,855
Cost of sales *[note 4]*	**15,183,293**	12,599,904
Gross profit	**4,966,148**	5,128,951
Expenses		
Sales and marketing *[note 4]*	**1,837,745**	1,517,260
Research and development *[note 4]*	**784,224**	816,921
General and administration *[note 4]*	**1,822,171**	1,447,673
	4,444,140	3,781,854
Income before other items	**522,008**	1,347,097
Other items		
Foreign exchange (gain) loss	**(99,271)**	147,674
Finance income	**(2,135)**	(12,632)
Finance costs *[note 5]*	**98,793**	190,465
Loss on disposal of assets	**—**	4,658
	(2,613)	330,165
Income before income taxes	**524,621**	1,016,932
Income taxes	**—**	—
Deferred income tax recovery *[note 14]*	**(1,592,000)**	—
Net icome for the year	**2,116,621**	1,016,932
Other comprehensive income (loss), net of tax, that is subject to reclassification to net income		
Foreign currency translation differences foreign operations	**(49,421)**	123,137
Total comprehensive income for the year	**2,067,200**	1,140,069
Income per share *[note 16]*		
Basic	**0.03**	0.02
Diluted	**0.03**	0.01
Weighted average common shares issued and outstanding *[note 16]*		
Basic	**66,269,515**	65,623,247
Diluted	**75,519,390**	75,226,580

See accompanying notes

Pacific Safety Products Inc.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

Year ended June 30

	Share capital $	Contributed surplus $	Other paid-in capital $	Deficit $	Accumulated other comprehensive income (loss) $	Total $
Balance, July 1, 2014	20,514,316	2,062,802	234,953	(20,871,796)	(82,440)	1,857,835
Net income for the year	—	—	—	1,016,932	—	1,016,932
Other comprehensive income						
Foreign currency translation differences	—	—	—	—	123,137	123,137
Total comprehensive income	—	—	—	1,016,932	123,137	1,140,069
Issuance of shares	40,000	—	—	—	—	40,000
Convertible debenture	—	—	34,610	—	—	34,610
Share-based compensation expense	—	12,850	—	—	—	12,850
Total amounts attributable to owners	40,000	12,850	34,610	—	—	87,460
Balance, June 30, 2015	20,554,316	2,075,652	269,563	(19,854,864)	40,697	3,085,364
Net income for the year	—	—	—	**2,116,621**	—	**2,116,621**
Other comprehensive loss						
Foreign currency translation differences	—	—	—	—	**(49,421)**	**(49,421)**
Total comprehensive income (loss)	—	—	—	**2,116,621**	**(49,421)**	**2,067,200**
Issuance of shares	**35,750**	—	—	—	—	**35,750**
Total amounts attributable to owners	**35,750**	—	—	—	—	**35,750**
Balance, June 30, 2016	**20,590,066**	**2,075,652**	**269,563**	**(17,738,243)**	**(8,724)**	**5,188,314**

See accompanying notes

Pacific Safety Products Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended June 30

	2016	2015
	$	$
OPERATING ACTIVITIES		
Cash receipts from customers	**19,948,611**	16,544,746
Cash paid to suppliers and employees	**(19,058,671)**	(17,097,944)
Interest paid	**(81,609)**	(178,669)
Interest received	**2,136**	12,632
Investment tax credits recovered	**93,276**	174,839
Cash provided by (used in) operating activities	**903,743**	(544,396)
INVESTING ACTIVITIES		
Purchase of property and equipment	**(115,144)**	(92,486)
Cash used in investing activities	**(115,144)**	(92,486)
FINANCING ACTIVITIES		
Issuance cost on debentures	**—**	(28,501)
Proceeds from exercise of stock options	**35,750**	10,000
Proceeds from new debentures	**—**	725,000
Repayment of debentures	**—**	(890,000)
Repayment of guaranteed investment certificate	**—**	1,040,000
Change in overdraft line of credit	**(160,000)**	(610,000)
Repayment of long-term debt	**(196,460)**	(214,320)
Cash provided by (used in) financing activities	**(320,710)**	32,179
Net increase (decrease) in cash and cash equivalents during the year	**467,889**	(604,703)
Cash, beginning of year	**128,255**	680,335
Effect of exchange rate fluctuations on cash held	**3,908**	52,623
Cash and cash equivalents end of year *[note 6]*	**600,052**	128,255

See accompanying notes

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2016

1. REPORTING ENTITY

Pacific Safety Products Inc. and its subsidiary ("PSP" or the "Company') is domiciled in Canada and incorporated under the *Canada Business Corporations Act,* and its shares are publicly traded on the TSX Venture Exchange (PSP: TSV). The registered office is located at 124 Fourth Avenue, Arnprior, Ontario K7S 0A9, in Canada.

The Company manufactures and sells a comprehensive line of protective products for the defense and security markets.

The consolidated financial statements comprise the accounts of the Company and its wholly owned subsidiary: GH Armor Systems Inc. ("GH"). GH is incorporated in the State of Delaware, USA, and commenced operations in Dover, Tennessee on July 5, 2006.

The consolidated financial statements of Pacific Safety Products Inc. and its subsidiary for the year ended June 30, 2016 were authorized for issue by the Board of Directors of the Company on September 28, 2016.

2. BASIS OF PREPARATION

[a] Statement of compliance

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

[b] Basis of measurement

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

[d] Basis of consolidation

The consolidated financial statements comprise the accounts of the Company and GH as at June 30, 2016.

The financial statements of the subsidiary are prepared for the same reporting period as the Company using consistent accounting policies. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between members of the Company are eliminated in full on consolidation.

2. BASIS OF PREPARATION (cont'd)

[e] Use of estimates and judgments

The preparation of the consolidated 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 estimates and judgments, which have the most significant effect on the amounts recognized in the consolidated financial statements:

[i] 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.

[ii] Income taxes

Deferred tax assets 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.

[iii] Allowance for doubtful accounts

The Company uses historical collection trends and performs specific account assessments when determining the allowance for doubtful accounts. AFDA is presented on the trade and other receivables line on the Company's consolidated statements of financial position. The estimate of the Company's allowance for doubtful accounts can change from period to period as it is a function of the underlying balance and composition of the accounts receivable. Additional bad debt charges may occur in the future based on actual receipts.

2. BASIS OF PREPARATION (cont'd)

[e] Use of estimates and judgments (cont'd)

[iv] Allowance for inventory obsolescence

The Company determines its allowance for inventory obsolescence based upon expected inventory turnover, inventory aging and current and future expectations with respect to product offerings. The Company reviews future revenue trends and forecasts, expected inventory requirements and inventory composition necessary to support future revenues. These accounting estimates are with respect to inventory on the Company's consolidated statements of financial position. The estimate for the Company's allowance for inventory obsolescence could change from period to period due to changes in product offerings and consumer acceptance of those products. If the estimate of inventory obsolescence was inadequate, it would result in a charge to operations expense in the future.

[v] Provisions

The Company estimates provisions for warranties and onerous contracts. A provision will be recognized if the Company has a legal or constructive obligation due to a prior event. Warranties are based on historical trends. Onerous contracts are based on an unavoidable cost in excess of any future benefit. The onerous contract provision is calculated at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing the contract. Details for these provisions can be found in note 11. The estimate for the Company's provisions could change from period to period due to changes in historical trends, revenue or the business environment.

[vi] Share-based compensation

The Company uses the Black-Scholes option-pricing model to determine the grant date fair value of share-based compensation. The following assumptions are used in the model: dividend yield; expected volatility; risk-free interest rate; expected option life; and fair value. Changes to assumptions used to determine the grant date fair value of share-based compensation awards can affect the amounts recognized in the consolidated financial statements.

3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all years presented in these consolidated financial statements unless otherwise indicated.

[a] Cash and cash equivalents

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

[b] Fair value measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurement is based on the presumption that the transaction to sell the asset or transfer the liability takes place either:

a. In the principal market for the asset or liability; or
b. In the absence of a principal market, in the most advantageous market for the asset or liability.

The principal or the most advantageous market must be accessible by the Company.

The fair value of an asset or a liability is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their best economic interest.

The Company uses valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.

All assets and liabilities for which fair value is measured or disclosed in the consolidated financial statements are categorized within the fair value hierarchy, described as follows, based on the lowest level input that is significant to the fair value measurement as a whole:

i. Level 1 – Quoted (unadjusted) market prices in active markets for identical assets or liabilities
ii. Level 2 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable
iii. Level 3 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[b] Fair value measurement (cont'd)

For assets and liabilities that are recognized in the consolidated financial statements on a recurring basis, the Company determines whether transfers have occurred between Levels in the hierarchy by reassessing categorization (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period.

For the purpose of fair value disclosures, the Company has determined classes of assets and liabilities on the basis of the nature, characteristics and risks of the asset or liability and the level of the fair value hierarchy as explained above.

[c] Foreign currencies

The Company's consolidated financial statements are presented in Canadian dollars, which is also the parent company's functional currency. For each entity, the Company determines the functional currency and items included in the financial statements of each entity are measured using that functional currency. The Company uses the direct method of consolidation.

i) Transactions and balances
Transactions in foreign currencies are initially recorded by the Company's entities at their respective functional currency spot rates at the date the transaction first qualifies for recognition.

Monetary assets and liabilities denominated in foreign currencies are translated at the functional currency spot rates of exchange at the reporting date. Differences arising on settlement or translation of monetary items are recognized in profit or loss. These are recognized in other comprehensive income (loss) until the net investment is disposed of, at which time the cumulative amount is reclassified to profit or loss. Tax charges and credits attributable to exchange differences on those monetary items are also recorded in other comprehensive income (loss).

Non-monetary items that are measured at historical cost in a foreign currency are translated using the exchange rates at the date of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value is determined. The gain or loss arising on translation of non-monetary items measured at fair value is treated in line with the recognition of gain or loss on change in fair value of the item (i.e., translation differences on items whose fair value gain or loss is recognized in other comprehensive income (loss) or profit or loss are also recognized in other comprehensive income (loss), or profit or loss, respectively).

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[c] Foreign currencies (cont'd)

ii) Group companies
On consolidation, the assets and liabilities of foreign operations are translated into Canadian dollars at the rate of exchange prevailing at the reporting date and their statements of income are translated at the monthly average exchange rates as an approximation of the exchange rates prevailing at the dates of the transactions. The exchange differences arising on translation for consolidation are recognized in other comprehensive income (loss). On disposal of a foreign operation, the component of other comprehensive income (loss) relating to that particular foreign operation is recognized in profit or loss.

[d] Revenue recognition

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Company and the revenue can be reliably measured, regardless of when the payment is being made. Revenue is measured at the fair value of the consideration received or receivable, taking into account contractually defined terms of payment and excluding taxes or duty. The Company has concluded that it is the principal in all of its revenue arrangements since it is the primary obligor in all the revenue arrangements, has pricing latitude and is also exposed to inventory and credit risks.

Revenue from the sale of goods is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer, usually on delivery of the goods, the associated costs and possible return of goods can be estimated reliably, and there is no continuing management involvement with the goods.

If it is probable that discounts will be granted and the amount can be measured reliably, then the discount is recognized as a reduction of revenue as the revenue is recognized.

[e] Income taxes

Current income taxes
Current income tax assets and liabilities for the current period are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted, at the reporting date in the countries where the Company operates and generates taxable income.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[e] Income taxes (cont'd)

Deferred taxes
Deferred taxes are provided using the liability method on temporary differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes at the reporting date.

The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilized. Unrecognized deferred tax assets are reassessed at each reporting date and are recognized to the extent that it has become probable that future taxable profits will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the reporting date.

Deferred tax assets and deferred tax liabilities are offset if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

Deferred tax assets are recognized for 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 judgement 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 any future tax planning strategies.

[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.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[f] Financial instruments (cont'd)

[i] Non-derivative financial assets (cont'd)

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 trade and other receivables.

Subsequent measurement

The subsequent measurement of financial assets depends on their classification.

[ii] Non-derivative financial assets

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.

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.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[f] Financial instruments (cont'd)

[iii] 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 trade and other payables, 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.

Derecognition

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

[iv] Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount presented in the consolidated statements 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.

[v] 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.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[f] Financial instruments (cont'd)

[vi] Compound financial instruments

Compound financial instruments issued by the Company comprise non-convertible debentures and 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.

Convertible debentures are separated into liability and equity components based on the terms of the contract.

On issuance of the non-convertible and convertible debentures, the fair value of the liability component is determined using a market rate for an equivalent non-convertible instrument, or instrument without an equity component.

This amount is classified as a financial liability measured at amortized cost (net of transaction costs) until it is extinguished on conversion or redemption.

The remainder of the proceeds is allocated to the conversion option or equity component that is recognized and included in equity. Transaction costs are deducted from equity, net of associated income taxes. The carrying amount of the conversion option or equity component is not remeasured in subsequent years.

Transaction costs are apportioned between the liability and equity components of the non-convertible and convertible debentures based on the allocation of proceeds to the liability and equity components when the instruments are initially recognized. Interest, losses and gains relating to the financial liability are recognized in profit or loss.

[g] Property and equipment

Property and equipment are stated at cost, net of accumulated depreciation and accumulated impairment losses, if any. Such cost includes the cost of replacing part of the property and equipment. When significant parts of property and equipment are required to be replaced at intervals, the Company recognizes such parts as individual assets with specific useful lives and depreciates them accordingly. All other repair and maintenance costs 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.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[g] Property and equipment (cont'd)

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	Shorter of useful lives or term of the leases

An item of property and equipment and any significant part initially recognized is derecognized upon disposal or when no future economic benefits are expected from its use or disposal.

Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the consolidated statements of income and comprehensive income when the asset is derecognized.

The residual values, useful lives and methods of depreciation of property, plant and equipment are reviewed at each financial year end and adjusted prospectively, if appropriate.

[h] Leases

The determination of whether an arrangement is (or contains) a lease is based on the substance of the arrangement at the inception date. The arrangement is assessed for whether fulfilment of the arrangement is dependent on the use of a specific asset or assets or the arrangement conveys a right to use the asset or assets, even if that right is not explicitly specified in an arrangement.

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

[i] Inventories

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

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[i] Inventories (cont'd)

Costs incurred in bringing each product to its present location and condition are accounted for as follows:

- Raw materials – standard cost, which approximates purchase cost on a weighted average basis
- Finished goods and work-in-progress – cost of direct materials and labor 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 the estimated costs necessary to make the sale.

[j] 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.

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

[i] 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.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[j] Impairment (cont'd)

[i] Non-financial assets (cont'd)

An impairment loss is recognized if the carrying amount of an asset 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 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 such 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.

[k] Share-based payment transactions

The grant-date fair value of share-based payment awards granted to employees is recognized as an employee expense, with a corresponding increase in equity, over the period that the employees become unconditionally entitled to the awards. The amount recognized as an expense is adjusted to reflect the number of awards for which the related service and non-market performance conditions are expected to be met, such that the amount ultimately recognized as an expense is based on the number of awards that meet the related service and non-market performance conditions at the vesting date. For share-based payment awards with non-vesting conditions, the grant-date fair value of the share-based payment is measured to reflect such conditions and there is no true-up for differences between expected and actual outcomes.

[l] 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.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[l] Provisions (cont'd)

Warranty provisions

Provisions for warranty-related costs are recognized when the product is sold or service provided to the customer. Initial recognition is based on historical experience. The initial estimate of warranty-related costs is revised annually.

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.

[m] Income per share

The Company presents basic and diluted income per share data for its common shares. Basic income 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 income 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.

[n] Segment reporting

An operating segment is a component of the Company that engages in business activities from which it may earn revenue and incur expenses, including revenue 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.

3. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[o] 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, 2016, and have not been applied in preparing these consolidated financial statements.

[i] IFRS 9 *Financial instruments*

IFRS 9 replaces International Accounting Standard ("IAS") 39, *Financial Instruments: Recognition and Measurement*, and establishes principles for the financial reporting of financial assets and financial liabilities to permit users to assess the amounts, timing and uncertainty of an entity's future cash flows. The standard retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets.

IFRS 9 is effective for annual periods beginning on or after January 1, 2018 with earlier application permitted. The Company has not yet adopted this standard and its adoption is not expected to have a material impact on the Company's consolidated financial statements.

[ii] IFRS 15 *Revenue from Contracts with Customers*

In May 2015, the International Accounting Standards Board and the US Financial Accounting Standards Board collectively, the Boards) issued their joint revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers*, which replaces all existing IFRS and US GAAP revenue requirements.

IFRS 15 establishes a five-step model that will apply to revenue earned from a contract with a customer (with limited exceptions), regardless of the type of revenue transaction or the industry. The standard's requirements will also apply to the recognition and measurement of gains and losses on the sale of some non-financial assets that are not an output of the entity's ordinary activities (e.g., sales of property, plant and equipment or intangible assets).

4. SIGNIFICANT ACCOUNTING POLICIES (cont'd)

[o] New standards and interpretations not yet adopted (cont'd)

[ii] IFRS 15 *Revenue from Contracts with Customers* (cont'd)

Application is required for annual periods beginning on or after January 1, 2017. Early adoption is permitted under IFRS. Entities will transition following either a full retrospective approach or a modified retrospective approach. The modified approach will allow the standard to be applied to existing contracts beginning with the current period. No restatement of the comparative periods will be required under this approach, as long as comparative disclosures about the current period's revenue under existing IFRS are included.

The Company expects the adoption of IFRS 15 will have no material impact on its consolidated financial statements.

4. NATURE OF EXPENSES

The table below is supplemental to the consolidated statements of income and comprehensive income; it presents the major functional expenses by their nature.

	2016	**2015**
	$	$
Direct material	**9,040,781**	7,697,019
Compensation, employees and directors	**6,719,058**	5,837,456
Professional services	**537,354**	334,779
Freight	**383,560**	384,335
Warranty	**358,956**	168,759
Product testing	**295,188**	197,730
Travel and living	**277,984**	276,494
Amortization	**158,459**	147,660
Samples	**141,928**	278,701
Other expenses	**1,714,165**	1,058,915
Total expenses	**19,627,433**	16,381,848

5. FINANCE COSTS

	2016	**2015**
	$	$
Interest on bank indebtedness	**6,289**	24,635
Interest on long-term debt	**5,839**	17,834
Interest on debentures	**71,943**	94,122
Accretion of debentures	**14,722**	53,874
	98,793	190,465

6. CASH AND CASH EQUIVALENTS

	2016	**2015**
	$	$
Bank balances	**600,052**	128,255
Cash and cash equivalents in the consolidated statement of cash flows	**600,052**	128,255

PSP has a credit agreement with a Canadian bank (the "Bank") for a credit facility in the amount of $1,550,000 [2015 – $900,000]. The facility is a revolving demand facility available by way of overdraft with interest payable monthly calculated at the bank prime lending rate plus 1.10% per annum. The facility is secured by a general security agreement constituting a first ranking security interest over all personal property of PSP and its subsidiary.

The Agreement has financial covenants, a ratio of Total Liabilities to Tangible Net Worth of not greater than 1.5:1 and a Debt Service Coverage ratio of not less than 1.25:1. As at June 30, 2, the amount drawn on the credit facility and overdraft facility was nil [2015 – $160,000], respectively. As at June 30, 2016, PSP is in compliance with its covenant.

The Company's exposure to interest rate risks and a sensitivity analysis for financial assets and liabilities are included in note 18.

7. TRADE AND OTHER RECEIVABLES

	2016 $	2015 $
Trade receivables	**3,435,552**	2,587,468
Allowance for doubtful accounts	**(13,986)**	(13,772)
Other receivables	**157,276**	829,331
	3,578,842	3,403,027

The Company had no trade receivables due from related parties as at June 30, 2016 or June 30, 2015. The Company's other receivables are mainly refundable deposits.

The Company's exposure to credit and currency risks and impairment losses related to trade and other receivables is disclosed in note 18.

8. INVENTORIES

	2016 $	2015 $
Raw materials and consumables	**1,443,748**	2,309,523
Work-in-process	**42,868**	153,656
Finished goods and samples	**131,734**	76,009
	1,618,350	2,539,188
Less provision	**(75,436)**	(656,746)
	1,542,914	1,882,442

A recovery of inventories of $51,328 was recorded as a credit in cost of sales during the year ended June 30, 2016 [2015 – $133,683 write-down].

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2016

9. PROPERTY AND EQUIPMENT

	Manufacturing equipment $	Office equipment $	Leasehold improvements $	Computer equipment $	Total $
Cost					
As at June 30, 2014	680,711	49,914	265,807	75,720	1,072,152
Additions	55,963	2,194	24,149	10,180	92,486
Disposals	(17,600)	—	—	(1,163)	(18,763)
Effect of movements in exchange rates	62,825	1,419	20,500	2,998	87,742
As at June 30, 2015	781,899	53,527	310,456	87,735	1,233,617
Additions	**50,139**	**2,110**	**59,971**	**2,924**	**115,144**
Effect of movements in exchange rates	**15,301**	**333**	**4,550**	**752**	**20,936**
As at June 30, 2016	**847,339**	**55,970**	**374,977**	**91,411**	**1,369,697**
Accumulated depreciation					
As at June 30, 2014	461,348	34,663	150,389	37,000	683,400
Depreciation	69,574	4,448	58,983	14,667	147,672
Disposals	(13,163)	—	—	(990)	(14,153)
Effect of movement in exchange rates	38,500	1,000	12,234	1,629	53,363
As at June 30, 2015	556,259	40,111	221,606	52,306	870,282
Depreciation	**70,439**	**3,720**	**72,493**	**11,837**	**158,489**
Effect of movement in exchange rates	**8,702**	**203**	**2,456**	**379**	**11,740**
As at June 30, 2016	**635,400**	**44,034**	**296,555**	**64,522**	**1,040,511**
Net book value					
As at June 30, 2015	225,640	13,416	88,850	35,429	363,335
As at June 30, 2016	**211,939**	**11,936**	**78,422**	**26,889**	**329,186**

10. TRADE AND OTHER PAYABLES

	2016 $	**2015** $
Due to related parties	**93,667**	101,167
Trade payables	**876,239**	614,909
Non-trade payables and accrued expenses	**782,851**	871,382
	1,752,757	1,587,458

The Company's exposure to currency and liquidity risks related to trade and other payables is disclosed in note 18.

11. PROVISIONS

	Warranties $	**Onerous Contracts** $	**Total** $
As at June 30, 2015	51,283	43,684	94,967
Provisions made during the year	**22,285**	**(21,975)**	**310**
Provisions used during the year	**—**	**—**	**—**
Effect of movements in exchange rates	**775**	**—**	**775**
As at June 30, 2016	**74,343**	**21,709**	**96,052**
Short-term	**14,869**	**21,709**	**36,578**
Long-term	**59,474**	**—**	**59,474**
Total	**74,343**	**21,709**	**96,052**

Warranties

The provision for warranties is based on estimates made from historical data associated with similar products.

Onerous contracts

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 of the provision as at June 30, 2016 was $21,709 [2015 – $43,684].

12. LONG-TERM DEBT

The Company's long-term debt consisted of a secured term loan with interest payable monthly, calculated at the Lender's floating base rate plus a variance rate of 0.75% per annum on outstanding principal. The base rate was 5% as at June 30, 2015. Debt was defined as long-term debt plus capital leases and book value of preferred shares subject to a formal redemption agreement. Principal was repayable in monthly instalments of $17,860; the final payment occurred on May 23, 2016.

13. CONVERTIBLE DEBENTURES

On February 17, 2015, the Company issued $749,000 of unsecured convertible debentures (the "Convertible Debentures") with the following terms: (i) interest payable annually at a rate of 10% in cash or common shares, at the option of the Company; (ii) three year term, with a maturity date of February 18, 2018, with early repayment possible, at the option of the Company, after one year from the date of issuance; (iii) convertible into common shares of the Company at the option of the holder at a rate of one common share per $0.15 of indebtedness.

On the date of issuance of the Convertible Debentures, the gross proceeds were allocated $713,020 to liabilities and $35,980 to equity, based on the fair value of the conversion option. The Debenture was measured initially at fair value and carried at amortized cost. The fair value of the Debenture was estimated to be $711,504 as at June 30, 2016 [2015 – $693,157] using the present value of future cash flows and effective interest rate of 12%. Interest expense is based on the effective interest method, with accretion expense of $8,949 recorded for the year ended June 30, 2016.

Certain officers and directors of the Company beneficially own or control, directly or indirectly $516,500 aggregate principal amount of the Convertible Debentures [2015 – $516,500 of the debentures].

14. INCOME TAXES

The reported income tax provision differs from the amount computed by applying the Canadian statutory rate to the net income for the following reasons:

	2016	**2015**
	$	$
Net accounting income before income taxes	**524,621**	1,016,932
Rate	**25.33%**	25.0%
Expected Canadian income tax expense	**132,886**	254,233
Reconciling items include:		
Foreign tax rate differential	**11,421**	67,618
Tax rate change on opening deferred tax benefits	**(36,725)**	**—**
Benefit of research and development tax credits	**(137,787)**	(360,799)
Non-deductible/(non-taxable) expenses for tax purposes	**(12,469)**	10,838
Change in benefit of deferred tax assets not recorded	**(1,649,000)**	(255,000)
Prior year adjustments and other items	**99,674**	283,110
Total income tax expense/(recovery)	**(1,592,000)**	—

The expected income tax rate reflects the combined federal and provincial income tax rate for manufacturing and processing companies.

14. INCOME TAXES (cont'd)

The Company's deferred income tax assets and liabilities include the following significant components.

	2016 $	2015 $
Deferred income tax assets		
Non-capital losses	**4,143,000**	4,111,000
Investment tax credits	**1,209,000**	1,201,000
Net capital losses	**1,107,000**	1,147,000
Intangible assets	**1,042,000**	817,000
Scientific research and experimental development expenditures	**892,000**	812,000
Reserves	**119,000**	122,000
Ontario research and development tax credits	**31,000**	40,000
Deferred financing costs	**9,000**	2,000
Property and equipment	**3,000**	4,000
	8,555,000	8,256,000
Deferred income tax liabilities		
Unrealized foreign exchange gains	**(587,000)**	(231,000)
Investment tax credits	**(306,000)**	(300,000)
Convertible debentures	**(9,000)**	(16,000)
Ontario research and development tax credits	**(8,000)**	(7,000)
	(910,000)	(554,000)
Net deferred income tax assets (liabilities)	**7,645,000**	7,702,000
Less: benefit of deferred income tax assets not recorded	**(6,053,000)**	(7,702,000)
	1,592,000	—

As at June 30, 2016, the Company has cumulative non-capital losses available to be carried forward in the following jurisdictions: Canada – $3,770,000 [2015 – 4,788,000], United States – $7,971,000 [2015 – 7,286,000]. The non-capital losses in Canada begin to expire in 2030. The net operating losses in the U.S. begin to expire in 2027. The Company also has net capital losses in Canada of $4,372,000, which do not have an expiry date. As at June 30, 2016, the Company has Federal investment tax credits of $1,209,000 [2015 – 1,201,000] available to reduce future Federal Canadian income taxes otherwise payable. The investment tax credits begin to expire in 2027.

In addition, the Company has Ontario research and development tax credits of $31,000, which are available to reduce future Ontario income taxes otherwise payable. The credits begin to expire in 2036.

The Company has scientific research and experimental development expenditures of $3,522,000 that can be carried forward indefinitely.

14. INCOME TAXES (cont'd)

The deferred tax benefits relating to the tax assets in the U.S. have not been recognized in the consolidated financial statements as the recognition requirements under the liability method of accounting for income taxes have not been met.

A portion of the deferred tax benefits relating to the tax assets in Canada have been recognized in the consolidated financial statements as it is probable that taxable profits will be available against which $1,592,000 [2015 – nil] of the deferred tax assets can be utilized. The balance of the Canadian deferred tax benefits remain unrecognized.

15. CAPITAL AND OTHER COMPONENTS OF EQUITY

Share capital

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

	2016		2015	
	Number of shares #	Amount $	Number of shares #	Amount $
Balance, beginning of year	**65,928,189**	**20,554,316**	65,466,005	20,514,316
Shares issued	**475,000**	**35,750**	462,184	40,000
Balance, end of year	**66,403,189**	**20,590,066**	65,928,189	20,554,316

On September 4, 2015, the Company issued 75,000 common shares to a former employee of the Company upon exercise of 75,000 stock options with an exercise price of $0.11.

On September 14, 2015, the Company issued 50,000 common shares to an employee of the Company upon exercise of 50,000 stock options with an exercise price of $0.11.

On October 2, 2015, the Company issued 150,000 common shares to an employee of the Company upon exercise of 150,000 stock options with an exercise price of $0.05.

On October 21, 2015, the Company issued 25,000 common shares to an employee of the Company upon exercise of 25,000 stock options with an exercise price of $0.11.

On November 6, 2015, the Company issued 125,000 common shares to an employee of the Company upon exercise of 125,000 stock options with an exercise price of $0.05.

15. CAPITAL AND OTHER COMPONENTS OF EQUITY (cont'd)

On December 15, 2015, the Company issued 50,000 common shares to an employee of the Company upon exercise of 50,000 stock options with an exercise price of $0.11.

Contributed surplus

	2016	**2015**
	$	$
Balance, beginning of year	**2,075,652**	2,062,802
Stock-based compensation	**—**	12,850
Balance, end of year	**2,075,652**	2,075,652

16. INCOME PER SHARE

The income and diluted income per common share are based on the weighted-average common shares outstanding during the year. The outstanding instruments could have the following dilutive effect in the future.

	2016	**2015**
	#	#
Shares issuable on conversion of convertible debentures	**5,189,875**	5,173,333
Stock options	**4,060,000**	4,610,000
	9,249,875	9,783,333

17. SHARE-BASED PAYMENT

The PSP Fixed Stock Option Plan ("the Fixed Plan") provides options to purchase common shares of the Company for its management, executive officers and members of the Board of Directors. Under the Fixed 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.

On November 12, 2015, the Board approved a new Rolling Stock Option Plan ("the Rolling Plan"), which replaced the existing Fixed Plan adopted April 5, 2013. Under the Rolling Plan, the number of established and outstanding stock options or grants shall not exceed 10% of the issued shares of the Company at the time the stock options are granted. As at June 30, 2016 the number of shares reserved for issuance under the Rolling Plan was 6,640,319. This represents the only change from the Fixed Plan, where the number of shares reserved for issuance was fixed at 5,950,489. All other terms of the Rolling Plan remain in accordance with the Fixed Plan.

17. SHARE-BASED PAYMENT (cont'd)

As at June 30, 2016, the Company had 4,060,000 [2015 – 4,610,000] stock options outstanding with a weighted average exercise price of $0.11 [2015 – $0.11].

	Total #	Weighted average exercise price $
Balance, June 30, 2014	4,375,000	0.10
Granted	250,000	0.20
Granted	360,000	0.095
Expired	(50,000)	0.05
Expired	(125,000)	0.11
Exercised	(200,000)	0.05
Balance, June 30, 2015	4,610,000	0.11
Exercised	**(475,000)**	0.075
Expired	**(75,000)**	0.11
Balance, June 30, 2016	**4,060,000**	0.11

	2016	**2015**
Total stock option pool authorized	**6,640,319**	5,950,489
Total stock option pool remaining	**2,580,319**	390,489

The following table summarizes information regarding the Company's outstanding stock options as at June 30, 2016.

Options outstanding				Options exercisable	
Range of exercise prices $	**Number outstanding**	**Weighted average remaining life (years)**	**Weighted average exercise price** $	**Number exercisable**	**Weighted average exercise price** $
0.10	1,250,000	1.28	0.10	1,250,000	0.10
0.11	2,200,000	2.40	0.11	2,200,000	0.11
0.20	250,000	0.35	0.20	250,000	0.20
0.095	360,000	0.54	0.095	360,000	0.095
0.11	**4,060,000**	**2.17**	**0.11**	**4,060,000**	**0.11**

18. FINANCIAL RISK MANAGEMENT

Credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was as follows:

	2016	**2015**
	$	$
Cash and cash equivalents	**600,052**	128,255
Trade and other receivables	**3,578,842**	3,403,027
	4,178,894	3,531,282

The carrying amounts of the financial assets of the Company approximate their fair values due to the relatively short periods to maturity of the instruments.

The Company's credit risk is attributable to its trade receivables. The amounts disclosed in the consolidated statements of financial position are net of allowances for impairment, estimated based on prior experience.

The maximum exposure to credit risk for trade and other receivables at the reporting date by geographic region is as follows:

	2016	**2015**
	$	$
Domestic	**1,894,803**	2,490,303
United States	**1,684,039**	912,724
	3,578,842	3,403,027

A significant customer represented approximately 16% [2015 – 13%] of the total trade and other receivables carrying amount as at June 30, 2016. There were two customers [2015 – two customers] that represented greater than 10% [2015 – 10%] of the total trade and other receivables as at June 30, 2016.

18. INANCIAL RISK MANAGEMENT (cont'd)

Impairment losses

The aging of trade receivables at the reporting date was as follows:

	2016		2015	
	Gross $	**Impairment** $	**Gross** $	**Impairment** $
Not past due	**2,426,346**	**—**	2,080,288	—
Past due 0 – 30 days	**361,067**	**—**	296,623	—
Past due 30 – 120 days	**305,659**	**(2,490)**	173,674	(2,579)
More than 120 days	**342,480**	**(11,496)**	36,883	(11,193)
Trade receivables	**3,435,552**	**(13,986)**	2,587,468	(13,772)
Other receivables	**—**	**—**	—	—
	3,435,552	**(13,986)**	2,587,468	(13,772)

The movement in the allowance for impairment in respect of trade receivables during the year was as follows:

	2016 $	**2015** $
Balance, July 1	**(13,772)**	(18,125)
Impairment loss recognized	**(214)**	(36,179)
Recovery	**—**	—
Write-offs	—	40,532
Balance, June 30	**(13,986)**	(13,772)

Trade receivables due for more than 60 days are analyzed and an allowance for impairment is recognized with consideration of the customers' credit ratings and historic payment behavior. The allowance account in respect of trade receivables is used to record impairment loss unless the Company is satisfied that no recovery of the amount owing is possible, at which point the amounts are considered irrevocable and are written off against the financial asset directly.

The Company believes that the unimpaired amounts past due by more than 30 days are collectible.

18. FINANCIAL RISK MANAGEMENT (cont'd)

Liquidity risk

As at June 30, 2016 and 2015, the Company did not have any derivative financial liabilities. The following are the contractual maturities of non-derivative financial liabilities including interest payments.

June 30, 2016	**Carrying amount and fair value** $	**Contractual Cash flows** $	**6 months or less** $	**6 – 12 months** $	**1 – 2 years** $	**2 – 5 years** $
Provisions	**96,052**	**96,052**	**19,670**	**16,908**	**14,868**	**44,606**
Convertible debentures	**711,504**	**898,800**	**74,900**	**—**	**823,900**	**—**
	807,556	**994,852**	**94,570**	**16,907**	**838,769**	**44,606**

June 30, 2015	**Carrying amount and fair value** $	**Contractual Cash flows** $	**6 months or less** $	**6 – 12 months** $	**1 – 2 years** $	**2 – 5 years** $
Provisions	94,967	94,967	17,364	17,364	34,729	25,510
Long-term debt	196,460	202,108	111,525	90,584	—	—
Convertible debentures	693,157	973,700	—	74,900	74,900	823,900
	984,584	1,270,775	128,889	182,848	109,629	849,410

18. FINANCIAL RISK MANAGEMENT (cont'd)

Currency risk

The Company's exposure to foreign currency risk is as follows:

June 30, 2016	**Exposure to USD** In CAD $
Cash and cash equivalents	**257,591**
Trade and other receivables	**1,684,039**
Trade and other payables	**(1,158,688)**
Provisions	**(38,556)**
Gross statement of financial position exposure	**744,386**

June 30, 2015	**Exposure to USD** In CAD $
Cash and cash equivalents	123,710
Trade and other receivables	912,725
Trade and other payables	(676,575)
Provisions	(21,897)
Gross statement of financial position exposure	337,963

18. FINANCIAL RISK MANAGEMENT (cont'd)

Sensitivity analysis

Based on the net exposures as at June 30, 2016 and 2015, and assuming all other variables remain constant, a 10% [2015 – 10%] depreciation or appreciation of the Canadian dollar against the US dollar would result in an increase (decrease) in net profit and loss by amounts shown.

June 30, 2016	**Impact of USD exposure in CAD** $
Canadian dollar	
Depreciation 10%	**74,439**
Appreciation 10%	**(74,439)**

June 30, 2015	**Impact of USD exposure in CAD** $
Canadian dollar	
Depreciation 10%	33,796
Appreciation 10%	(33,796)

Interest rate risk

	2016 $	**2015** $
Fixed rate instruments		
Financial liabilities	**(711,504)**	(693,157)
	(711,504)	(693,157)
Variable rate instruments		
Financial liabilities	**—**	(353,618)
	—	(353,618)

Guaranteed investment certificates comprise the Company's fixed rate financial assets for the year ended June 30, 2015. The Company does not account for any fixed rate financial assets at fair value through profit or loss.

The Company is exposed to interest rate risk on variable rate financial liabilities consisting of short-term variable rate credit facilities and a long-term variable rate secured loan for the year ended June 30, 2016. If interest rates on the credit facilities and long-term debt were to fluctuate by 1%, and all other variables were held constant, there would be an impact on profit or loss amounting to nil.

18. FINANCIAL RISK MANAGEMENT (cont'd)

Fair value

The Company's financial instruments consist of cash and cash equivalents, trade and other receivables, bank indebtedness, trade and other payables, convertible debentures and long-term debt. The fair values of trade and other receivables, bank indebtedness, and trade and other payables, as recorded in the consolidated statements of financial positions approximate their carrying amounts due to the short-term maturities of these instruments. The long-term debt reflects current market interest rates and therefore the carrying amount approximates fair value. Debentures were measured initially at fair value and are carried at amortized cost. The fair value of the Debentures was estimated to be $711,504 as at June 30, 2016 [2015 – $693,157] using the present value of future cash flows and an effective interest rate of 12%.

There are no financial instruments measured at fair value. During the years ended June 30, 2016 and, 2015, there have been no transfers of amounts between any categories. There were no items classified as Level 2, except the Debentures, and there were no items classified as Level 3 as at June 30, 2016 and 2015.

19. COMMITMENTS

The Company is committed to future minimum rentals payable under non-cancellable operating leases in respect of its premises and equipment as follows:

	2016 $
Less than 1 year	**353,306**
Between 1 and 5 years	**1,217,883**
Later than 5 years	**—**
	1,571,189

On August 16, 2011, the Company signed a sublease for the remaining lease term for its former head office premises in Kanata, Ontario. The lease and sublease expire in 2017. The Company recognized a provision of $122,308 in respect of this lease. The balance of the provision as at June 30, 2016 was $21,709 [2015 – $43,684].

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2016

20. OPERATING SEGMENTS

The Company's principal business activity is the manufacture and sale of a comprehensive line of protective products and accessories for the defense and security market. The Company operates in three segments: 1) Canada through PSP operation based in Arnprior, Ontario, 2) in the U.S. through its GH subsidiary located in Dover, Tennessee and 3) 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.

Transfer prices between operating segments are on an arm's length basis in a manner similar to transactions with third parties.

For the year ended June 30, 2016

	Canadian operations $	**U.S. operations** $	**Corporate** $	**Consolidated total** $
Revenue	**10,662,563**	**9,688,274**	—	**20,350,837**
Elimination of inter-segment revenue	**(158,759)**	**(42,637)**	—	**(201,396)**
Total revenue	**10,503,804**	**9,645,637**	—	**20,149,441**
Gross profit	**2,894,573**	**2,071,575**	—	**4,966,148**
Expenses	**2,221,402**	**1,412,637**	**810,101**	**4,444,140**
Other items	**(93,003)**	—	**90,390**	**(2,613)**
Deferred income tax recovery	**1,592,000**	—	—	**1,592,000**
Net income (loss) after taxes	**2,358,174**	**658,938**	**(900,491)**	**2,116,621**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2016

20. OPERATING SEGMENTS (cont'd)

For the year ended June 30, 2015

	Canadian operations $	U.S. operations $	Corporate $	Consolidated total $
Revenue	11,464,677	6,622,202	—	18,086,879
Elimination of inter-segment revenue	(94,186)	(263,838)	—	(358,024)
Total revenue	11,370,491	6,358,364	—	17,728,855
Gross profit	3,549,129	1,579,822	—	5,128,951
Expenses	2,308,772	971,807	501,275	3,781,854
Other items	164,336	—	165,829	330,165
Net income (loss) after taxes	1,076,021	608,015	(667,104)	1,016,932

As at June 30, 2016

	Canadian operations $	U.S. operations $	Corporate $	Consolidated total $
Assets				
Current assets	**3,125,395**	**2,692,297**	**—**	**5,817,692**
Property and equipment	**163,370**	**165,816**	**—**	**329,186**
Prepaid deposits	**33,228**	**—**	**—**	**33,228**
Deferred tax asset	**1,592,000**	**—**	**—**	**1,592,000**
	4,913,993	**2,858,113**	**—**	**7,772,106**
Liabilities				
Current liabilities	**1,104,756**	**584,910**	**123,148**	**1,812,814**
Convertible debenture	**—**	**—**	**711,504**	**711,504**
Long-term provisions	**28,630**	**30,844**	**—**	**59,474**
	1,133,386	**615,754**	**834,652**	**2,583,792**

20. OPERATING SEGMENTS (cont'd)

As at June 30, 2015

	Canadian operations $	U.S. operations $	Corporate $	Consolidated total $
Assets				
Current assets	3,707,068	1,762,109	—	5,469,177
Property and equipment	154,032	209,303	—	363,335
Prepaid deposits	57,073	—	—	57,073
	3,918,173	1,971,412	—	5,889,585
Liabilities				
Current liabilities	1,315,247	536,052	196,460	2,047,759
Convertible debenture	—	—	693,157	693,157
Long-term provisions	45,787	17,518	—	63,305
	1,361,034	553,570	889,617	2,804,221

Revenue for the year ended June 30 is as follows:

	2016 $	2015 $
Canada	**10,388,067**	11,370,491
United States	**9,735,422**	6,354,276
International	**25,952**	4,088
	20,149,441	17,728,855

Included in Fiscal 2016 was revenue of $3.7 million from the Canadian Federal Government [Fiscal 2015 – $4.1 million], which represents 18.3% [Fiscal 2015 – 23.4%] of total revenue. There were no other significant sales over 10% of total revenue to any one customer.

The Company experiences revenue 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2016

21. RELATED PARTIES

Key management personnel of the Company include the CEO, the Chief Financial Officer and all members of the Board of Directors. Related party transactions conducted are on an arm's length basis in a manner similar to transactions with third parties.

Key management personnel compensation consist of the following:

	2016 $	2015 $
Short-term employee benefits	**235,000**	195,000
Board of Directors fees	**40,000**	40,000
	275,000	235,000

Trade and other payables as at June 30, 2016 include interest payable to the directors and a former director of $123,148 [June 30, 2015 – $119,799].

On February 18, 2015, interest of $51,650 for debenture holders who are officers or directors of the Company was settled in cash. Certain officers and directors of the Company beneficially own or control, directly or indirectly, $516,500 aggregated principal amount of the Convertible Debentures [2015 – $516,500 of the debentures].

The Company also has related party sales with its subsidiary in the US. The total related party sales for the period ended June 30, 2016 was $201,396 [2015 – 358,024].

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