Pacific Safety Products Inc.

REPORT TO SHAREHOLDERS

MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED DECEMBER 31, 2015 and 2014

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 February 29, 2016 and should be read together with the audited annual consolidated financial statements and the notes thereto for the three months ended December 31, 2015, and the audited annual consolidated financial statements and the notes thereto for the year ended June 31, 2015, and the Management Information Circular dated November 12, 2015. Management is responsible for the preparation and integrity of the consolidated financial statements, including maintenance of appropriate information systems, procedures and internal controls, and to ensure that information used internally or disclosed externally, including the consolidated financial statements and management's discussion and analysis, is complete and reliable. All figures are in **Canadian dollars except as otherwise noted.**

The financial data has been prepared in accordance with IAS 34 *Interim Financial Reporting* and International Financial Reporting Standards ("IFRS") except where otherwise stated and the Company's reporting currency is the Canadian dollar. Pacific Safety Products Inc. is a reporting issuer in Canada in the provinces of British Columbia, Alberta and Ontario. The Company trades on the TSX Venture Exchange under the symbol "PSP". Additional regulatory information relating to Pacific Safety Products Inc. can be found at the System for Electronic Document Analysis and Retrieval ("SEDAR") website at www.sedar.com.

**FORWARD-LOOKING INFORMATION**

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

The forward-looking information is based on current expectations and assumptions regarding expected growth, results of operations, financial performance and business prospects and opportunities. Forward-looking information is subject to known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company, or general industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. These factors include, but are not limited to, the possible failure to successfully plan and execute business improvement strategies, restrictions and covenants contained in the Company's credit agreements, the potential impact of the current economic downturn on the Company's business, the unpredictability of purchasing patterns by governmental agencies, the possibility of a deterioration in the Company's working capital position, the impact that changes in supplier payment terms or slow payment of accounts receivable could have on the Company's liquidity, the unavailability of or increase in price of external capital to finance the Company's research, development and growth initiatives, changes in the laws, regulations, policies and economic conditions, including inflation, interest and foreign currency exchange rate fluctuations of countries in which the Company does business, competition in the Company's markets, successful integration of structural changes, including 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 February 29, 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 defense 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 February 9, 2016 the Credit Agreement with a Canadian bank (the "Bank") for a credit facility was increased to the amount of $1.6 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 October 14, 2015 the rate on our long-term debt was reduced by 0.75%.

On June 30, 2015 the Company's 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 has seen 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 has also entered 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.

Part II: RESULTS

| ***SUMMARY OF OPERATIONS*** | **THREE MONTHS ENDED DECEMBER 31, 2015** | THREE MONTHS ENDED DECEMBER 31, 2014 | **SIX MONTHS ENDED DECEMBER 31, 2015** | SIX MONTHS ENDED DECEMBER 31, 2014 |
|---|---|---|---|---|
| **REVENUES** | **$ 4,420,883** | $ 3,515,938 | **$ 9,382,127** | $ 7,248,103 |
| **COST OF SALES** | **3,479,191** | 2,548,536 | **7,232,514** | 5,210,827 |
| **GROSS MARGIN** | **941,692** | 967,402 | **2,149,613** | 2,037,276 |
| **EXPENSES** | **1,072,118** | 1,005,431 | **2,066,714** | 1,952,130 |
| **INCOME (LOSS) BEFORE OTHER ITEMS** | **(130,426)** | (38,029) | **82,899** | 85,146 |
| **OTHER ITEMS** | **(134,265)** | 48,036 | **(197,193)** | 133,690 |
| **INCOME (LOSS) BEFORE INCOME TAXES** | **3,839** | (86,065) | **280,092** | (48,544) |
| **INCOME TAXES** | **—** | — | **—** | — |
| **NET INCOME (LOSS) FOR THE PERIOD** | **$ 3,839** | $ (86,065) | **$ 280,092** | $ (48,544) |
| **OTHER COMPREHENSIVE INCOME (LOSS)** | **(47,659)** | (2,202) | **(49,941)** | 52,245 |
| **TOTAL COMPREHENSIVE INCOME (LOSS) FOR THE PERIOD** | **(43,820)** | (88,267) | **230,151** | 3,701 |
| **INCOME PER SHARE -** | | | | |
| **BASIC** | **$ -** | $ - | **$ -** | $ - |
| **DILLUTED** | **$ -** | $ - | **$ -** | $ - |

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

| | **THREE MONTHS ENDED DECEMBER 31, 2015** | THREE MONTHS ENDED DECEMBER 31, 2014 | **SIX MONTHS ENDED DECEMBER 31, 2015** | SIX MONTHS ENDED DECEMBER 31, 2014 |
|---|---|---|---|---|
| **NET INCOME (LOSS) FOR THE PERIOD** | **$ 3,839** | $ (86,065) | **$ 280,092** | $ (48,544) |
| **FINANCE COSTS, NET** | **26,527** | 55,273 | **51,221** | 112,745 |
| **DEPRECIATION AND AMORTIZATION** | **37,718** | 35,686 | **75,865** | 68,573 |
| **EBITDA** | **$ 68,084** | $ 4,894 | **$ 407,178** | $ 132,774 |
| **FOREIGN EXCHANGE (GAIN) LOSS** | **(160,792)** | (7,237) | **(248,414)** | 20,945 |
| **SHARE BASED COMPENSATION** | **-** | 5,000 | **-** | 5,000 |
| **ADJUSTED EBITDA (LOSS)** | **$ (92,708)** | **$ 2,657** | **$ 158,764** | **$ 158,719** |

| ***FINANCIAL POSITION*** | **AS AT DECEMBER 31, 2015** | AS AT JUNE 30, 2015 |
|---|---|---|
| **TOTAL ASSETS** | **$ 5,845,098** | $ 5,889,585 |
| **TOTAL LONG-TERM FINANCIAL LIABILITIES** | **$ 757,589** | $ 756,462 |

**Revenues**

Revenues for the three months ended December 31, 2015 were $4.4 million, an increase of $0.9 million or 25.7% as compared with the same period in the prior year. Revenues from Canadian customers for the three months ended December 31, 2015 were $2.1 million, a decrease of $0.1 million or 4.5% compared to the same period in the prior year. Revenues from U.S. and International customers for the three months ended December 31, 2015 were $2.3 million, an increase of $1.0 million or 76.9% compared to the same period in the prior year. The increase is primarily due to new products being introduced along with new/additional sales reps in the western states.

Revenues for the six months ended December 31, 2015 were $9.4 million, an increase of $2.2 million or 30.5% as compared with the same period in the prior year. Revenues from Canadian customers for the six months ended December 31, 2015 were $5.1 million, an increase of $0.8 million or 18.6% compared to the same period in the prior year. The increase relates primarily to increased quantities and the timing of orders for key contracts. Revenues from U.S. and International customers for the six months ended December 31, 2015 were $4.3 million, an increase of $1.3 million or 43.3% compared to the same period in the prior year. The increase is primarily due to new products being introduced along with new/additional sales reps in the western states.

**Gross Margin**

For the three months ended December 31, 2015, gross margin as a percentage of revenues was 21.3%, a decrease of 6.2% compared with the same period in the prior year. The decrease relates primarily due to lower margins from launching new products in the U.S.

For the six months ended December 31, 2015, gross margin as a percentage of revenues was 22.9%, a decrease of 5.2% compared with the same period in the prior year. The decrease relates to one time government contract in the U.S. plus lower margins from launching new products in the U.S.

**Expenses**

For the three and sixth months ended December 31, 2015, expenses were materially consistent with the same periods in the prior year, both in total and when separated into sales and marketing, research and development, and general and administration expenses. The only significant difference was a $0.1 million increase in sales and marketing related to the increase in U.S. sales.

**Foreign exchange losses (gains)**

For the six months ended December 31, 2015, foreign exchange gain was $0.25 million as compared to a loss of $0.02 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 six months ended December 31, 2015, finance costs were $0.05 million a decrease of $0.07 compared with the same period in the prior year.

**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.

**Net income for the period**

For the three months ended December 31, 2015, the Company recorded a net income of $0.004 million as compared to a net loss of $0.09 million in the prior year. The increase in income was assisted by favourable exchange rates on U.S. working Capital as compared with the same period in the prior year.

For the six months ended December 31, 2015, the Company recorded a net income of $0.3 million as compared to a net loss of $0.05 million in the prior year. The increase in income was assisted by favourable exchange rates on U.S. working Capital as compared with the same period in the prior year.

**Other comprehensive income (loss)**

For the three months ended December 31, 2015, the Company recorded other comprehensive loss of $0.05 million compared to a loss of $0.002 million during the same period in the prior year. The decrease in other comprehensive income is due to foreign currency translation differences relating to foreign operations.

For the six months ended December 31, 2015, the Company recorded other comprehensive loss of $0.05 million compared to income of $0.05 million during the same period in the prior year. The decrease in other comprehensive income is due to foreign currency translation differences relating to foreign operations.

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

Adjusted EBITDA is not a recognized performance measure under 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 loss for the year.

For the three months ended December 31, 2015 Adjusted EBITDA loss was $0.09 million compared to an Adjusted EBITDA of $0.002 million during the same period in the prior year.

For the six months ended December 31, 2015 Adjusted EBITDA was $0.16 million compared to an Adjusted EBITDA of $0.16 million during the same period in the prior year.

**Part III: CASH FLOW**

| ***CASH FLOW FROM (USED IN)*** | ***SIX MONTHS ENDED DECEMBER 31, 2015*** | *SIX MONTHS ENDED DECEMBER 31, 2014* |
|---|---|---|
| Operating activities | **$ 415,862** | $ (800,095) |
| Investing activities | **(55,354)** | (86,692) |
| Financing activities | **(21,410)** | 162,840 |
| Increase (decrease) in cash and cash equivalents, net of bank overdraft used for cash management purposes | **$ 339,098** | $ (723,947) |

Cash flow from operating activities for the six months ended December 31, 2015 was $0.4 million as compared to cash flows used in operating activities of $0.8 million during the same period in the prior year. The difference in cash flow from operating activities is due to the timing of purchasing and collections of large orders from our customers and a net increase in operating income.

Cash flow used in investing activities for the six months ended December, 2015 was $0.06 million as compared to $0.08 million during the same period in the prior year.

Cash flow used in financing activities for the six months ended December 31, 2015 relates to repayments of long-term debt consistent with the prior year and a net change in our operating line to cover timing of cash requirements. The positive cash flow from financing activities in the comparative period is a result of the GIC previously held as collateral against the line of credit being released.

**Part IV: LIQUIDITY AND CAPITAL RESOURCES**

| *AS AT* | ***DECEMBER 31, 2015*** | *JUNE 30, 2015* |
|---|---|---|
| Cash and cash equivalents | **$ 511,325** | **$** 128,255 |
| Bank indebtedness | **(210,000)** | (160,000) |
| Working capital | **3,686,084** | 3,387,010 |
| Long-term debt (long-term portion only) | **(703,399)** | (693,157) |
| Shareholders' equity | **(3,351,265)** | (3,050,956) |

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.

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. In 2016 and 2015 the company has been able to maintain expenses relative to revenues.

## Working Capital

At December 31, 2015, PSP's working capital was $3.7 million compared to $3.4 million as at June 30, 2015. The working capital reflects a decrease in trade and other receivables of $0.6 million, an increase in inventory of $0.1 million, a decrease in trade and other payables of $0.2 million and a net increase in cash and cash equivalents of $0.4 million with the net increase from the new operating line of $0.05 million.

Accounts receivable as at December 31, 2015 were $2.8 million compared to $3.4 million as at June 30, 2015. The decrease in accounts receivable reflects the cyclical timing in revenues in the three months ended December 31, 2015 compared to the three months ended June 31, 2015 and the timing of collection of those revenues.

Inventory as at December 31, 2015 increased by $0.2 million to $2.0 million as compared June 30, 2015. This increase is primarily related to an increase and timing of specific contracts.

Accounts payable and accrued liabilities as at December 31, 2015 were $1.4 million compared to $1.6 million as at June 30, 2015. The decrease reflects the 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 $0.9 million moving to $1.6 million. The facility is a revolving demand facility available by way of overdraft with interest payable monthly calculated at the bank prime lending rate plus 1.95% 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 Funded Debt to EBITDA, calculated on a rolling 4 quarters basis for the fiscal quarter then ended and the immediately preceding 3 fiscal quarters, of not greater than 3:1. At December 31, 2015 $0.2 million (June 30, 2015 – $0.2 million) was drawn on the credit facility and PSP was in compliance with the financial covenant.

## Long-term Debt

The Company has a secured term loan with the Business Development Bank of Canada ("BDC" or the "Lender"). The Company's lending rate was reduced on October 14, 2015 by 0.75%. At December 31, 2015, the principal outstanding on the loan was $0.1 million.

## 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 $5,720 recorded for the six months ended December 31, 2015.

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 December 31, 2015 the Company has cumulative non-capital losses available to be carried forward in the following jurisdictions: Canada - $4,145,000 United States - $7,487,000. The non-capital losses in Canada begin to expire in 2029. The net operating losses in the U.S. begin to expire in 2026 and 2032. The Company also has net capital losses in Canada of $4,327,000.

The income tax benefits relating to the losses in Canada and 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.

As at June 30, 2015 the Company has Federal investment tax credits of $1,201,000 available to reduce future Federal Canadian income taxes payable. The investment tax credits begin to expire in 2026.

In addition, the Company has Ontario research and development tax credits of $40,000 which are available to reduce future Ontario income taxes payable. The credits begin to expire in 2034.

The Scientific Research and Experimental Development expenditures of $3,247,000 can be carried forward indefinitely.

## Capital and Other Components of Equity

At December 30, 2015 the Company's issued and outstanding shares were 66,403,189 compared to 65,928,189 at June 30, 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 September 30, 2015, unchanged from June 30, 2015.

Other paid-in capital of $0.3 million at June 30, 2015 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** | | | **December 31, 2015** | **September 30, 2015** |
|---|---|---|---|---|
| **Revenues** | | | **$ 4,420,883** | **$ 4,961,244** |
| **Net income (loss) for the period** | | | **3,839** | **276,253** |
| **Basic and diluted earnings (loss) per share** | | | **-** | **-** |

| 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 | 0.02 | - | - | - |

| 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 December 31, 2015, the Company recorded net income from operations of $0.004 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 $0.28 million or $0.00 per share. 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 $825,000 which was partially recognized in prior quarters.

For the three months ended March 31, 2015, the Company recorded net income from operations of $0.08 million. The increase in income compared to the prior quarter is primarily due to higher volumes generating higher gross margins offset by R&D cost for Certifications of new products, legal, consulting and unfavourable exchange rates for the three months ended June 30, 2015.

For the three months ended December 31, 2014, the Company recorded net loss from operations of $0.2 million. The decrease in income compared to the prior quarter is primarily due to higher R&D cost for Certifications of new products, legal, consulting and unfavourable exchange rates for the three months ended December 31, 2014.

## Part VI: SIGNIFICANT 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, 2015.

**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 December 31, 2015, the trade and other receivables line represented 48% 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 December 31, 2015, the inventory line represented 34% 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 10 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 indebtedness and by virtue of the inter-lender agreement, the Lender and the Debenture holders may also demand repayment.

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

### Other Risks

Refer to the Company's June 30, 2015 consolidated financial statements note 18 for other risks including credit risk, liquidity risk, currency risk, interest rate risk, and fair value of financial instruments.

## Part VIII: OTHER INFORMATION

Condensed Consolidated Interim Financial Statements of

# PACIFIC SAFETY PRODUCTS INC.

Six months ended December 31, 2015 and 2014

(Unaudited)

**Pacific Safety Products Inc.**
**CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**
**(Unaudited)**

**FOR THE SIX MONTHS ENDED DECEMBER 31, 2015 and 2014**

## Notice to Reader

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

Terry Vaudry
Chief Executive Officer

February 29, 2016

**Pacific Safety Products Inc.**

## CONDENSED CONSOLIDATED INTERIM STATEMENT OF FINANCIAL POSITION

**(Unaudited)**

| | December 31, 2015 | June 30, 2015 |
|---|---|---|
| | $ | $ |
| **ASSETS** | | |
| **Current** | | |
| Cash and cash equivalents | **511,325** | 128,255 |
| Trade and other receivables | **2,809,543** | 3,403,027 |
| Inventories | **1,981,597** | 1,882,442 |
| Prepaid expenses | **119,863** | 55,453 |
| **Total current assets** | **5,422,328** | 5,469,177 |
| Property and equipment *[note 5]* | **365,697** | 363,335 |
| Prepaid deposits | **57,073** | 57,073 |
| | **5,845,098** | 5,889,585 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current** | | |
| Bank indebtedness *[notes 6]* | **210,000** | 160,000 |
| Trade and other payables | **1,369,619** | 1,587,458 |
| Short-term provisions *[note 9]* | **32,135** | 31,662 |
| Deferred revenue | **35,190** | 72,179 |
| Current portion of long-term debt *[note 7]* | **89,300** | 196,460 |
| **Total current liabilities** | **1,736,244** | 2,047,759 |
| Long-term provisions *[note 9]* | **54,190** | 63,305 |
| Convertible debentures *[note 8]* | **703,399** | 693,157 |
| | **2,493,833** | 2,804,221 |
| **Shareholders' equity** | | |
| Share capital *[note 10]* | **20,590,066** | 20,554,316 |
| Contributed surplus | **2,075,652** | 2,075,652 |
| Other paid-in capital | **269,563** | 269,563 |
| Deficit | **(19,574,772)** | (19,854,864) |
| Accumulated other comprehensive loss | **(9,244)** | 40,697 |
| **Total shareholders' equity** | **3,351,265** | 3,085,364 |
| | **5,845,098** | 5,889,585 |

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

**Pacific Safety Products Inc.**

## CONDENSED CONSOLIDATED INTERIM STATEMENT OF INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)

(Unaudited)

**For the three and six month periods ended December 31, 2015 and 2014**

| | **Three Months ended December 31, 2015** | Three Months ended December 31, 2014 | **Six Months ended December 31, 2015** | Six Months ended December 31, 2014 |
|---|---|---|---|---|
| | $ | $ | $ | $ |
| **Revenue** | **4,420,883** | 3,515,938 | **9,382,127** | 7,248,103 |
| Cost of sales | **3,479,191** | 2,548,536 | **7,232,514** | 5,210,827 |
| **Gross margin** | **941,692** | 967,402 | **2,149,613** | 2,037,276 |
| **Expenses** | | | | |
| Sales and marketing | **423,219** | 339,239 | **794,598** | 686,273 |
| Research and development | **186,431** | 197,168 | **360,895** | 463,374 |
| General and administration | **462,468** | 469,024 | **911,221** | 802,483 |
| **Total expenses** | **1,072,118** | 1,005,431 | **2,066,714** | 1,952,130 |
| Income (loss) before other items | **(130,426)** | (38,029) | **82,899** | 85,146 |
| **Other items** | | | | |
| Foreign exchange (gain) loss | **(160,792)** | (7,237) | **(248,414)** | 20,945 |
| Finance income | **(138)** | (2,698) | **(314)** | (12,380) |
| Finance costs *[note 4]* | **26,665** | 57,971 | **51,535** | 125,125 |
| **Total other items** | **(134,265)** | 48,036 | **(197,193)** | 133,690 |
| Income (Loss) before income taxes | **3,839** | (86,065) | **280,092** | (48,544) |
| **Income taxes** | | | | |
| Current income tax recovery | **—** | — | **—** | — |
| **Net Income (Loss) for the period** | **3,839** | (86,065) | **280,092** | (48,544) |
| **Other comprehensive income (loss), net of tax, that is subject to reclassification to net income** | | | | |
| Foreign currency translation differences – foreign operations | **(47,659)** | (2,202) | **(49,941)** | 52,245 |
| **Total comprehensive income (loss) for the period** | **(43,820)** | (88,267) | **230,151** | 3,701 |
| **Income per share** *[note 12]* | | | | |
| Basic and diluted | **—** | **—** | **—** | **—** |
| **Weighted average common shares issued and outstanding** | | | | |
| Basic and diluted | **66,305,363** | 65,555,249 | **66,126,022** | 65,510,627 |

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

**Pacific Safety Products Inc.**

## CONDENSED CONSOLIDATED INTERIM STATEMENT OF CHANGES IN EQUITY

**(Unaudited)**

**For the six months ended December 31, 2015 and 2014**

| | Share Capital | Contributed surplus | Other paid-in capital | Deficit | Cumulative translation account | Total |
|---|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ | $ |
| **Balance, July 1, 2014** | 20,514,316 | 2,062,802 | 234,953 | (20,871,796) | (82,440) | 1,857,835 |
| Net loss for the period | — | — | — | (48,544) | — | (48,544) |
| Other comprehensive income | | | | | | |
| Foreign currency translation differences | — | — | — | — | 52,245 | 52,245 |
| **Total comprehensive income (loss)** | — | — | — | (48,544) | 52,245 | 3,701 |
| Issuance of shares | 10,000 | — | — | — | — | 10,000 |
| Share-based compensation expense | — | 12,850 | — | — | — | 12,850 |
| Total amounts attributable to owners | 10,000 | 12,850 | — | — | — | 22,850 |
| **Balance, December 31, 2014** | 20,524,316 | 2,075,652 | 234,953 | (20,920,340) | (30,195) | 1,884,386 |
| **Balance, July 1, 2015** | **20,554,316** | **2,075,652** | **269,563** | **(19,854,864)** | **40,697** | **3,085,364** |
| Net Income for the period | — | — | — | **280,092** | — | **280,092** |
| Other comprehensive income | | | | | | |
| Foreign currency translation differences | — | — | — | — | **(49,941)** | **(49,941)** |
| **Total comprehensive income (loss)** | — | — | — | **280,092** | **(49,941)** | **230,151** |
| Issuance of shares | **35,750** | — | — | — | — | **35,750** |
| **Total amounts attributable to owners** | **35,750** | — | — | — | — | **35,750** |
| **Balance, December 31, 2015** | **20,590,066** | **2,075,652** | **269,563** | **(19,574,772)** | **(9,244)** | **3,351,265** |

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

**Pacific Safety Products Inc.**

## CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS

**(Unaudited)**
**For the six months ended December 31, 2015 and 2014**

| | **Six Months ended December 31, 2015** | Six Months ended December 31, 2014 |
|---|---|---|
| | $ | $ |
| **OPERATING ACTIVITIES** | | |
| Cash receipts from customers | **10,855,712** | 6,907,938 |
| Cash paid to suppliers and employees | **(10,433,029)** | (7,585,210) |
| Interest paid | **(7,136)** | (135,203) |
| Interest received | **315** | 12,380 |
| **Cash used in operating activities** | **415,862** | (800,095) |
| **INVESTING ACTIVITY** | | |
| Purchase of property and equipment | **(55,354)** | (86,692) |
| **Cash used in investing activity** | **(55,354)** | (86,692) |
| **FINANCING ACTIVITY** | | |
| Proceeds from exercise of stock options | **35,750** | — |
| Repayment of GIC | **—** | 1,040,000 |
| Change in Overdraft Line of Credit | **50,000** | (770,000) |
| Repayment of long-term debt | **(107,160)** | (107,160) |
| **Cash used in financing activity** | **(21,410)** | 162,840 |
| **Net increase (decrease) in cash and cash equivalents during the period** | **339,098** | (723,947) |
| Cash and cash equivalents, beginning of period | **128,255** | 680,335 |
| Effect of exchange rate fluctuations on cash held | **43,972** | 61,719 |
| **Cash and cash equivalents, (net of bank indebtedness) ending** *[note 5]* | **511,325** | 18,107 |

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

## 1. REPORTING ENTITY

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

The condensed consolidated interim financial statements of the Company as at and for the 6 months ended December 31, 2015 comprise the Company and its subsidiary. GH Armor Systems Inc. ("GH") is a wholly-owned subsidiary of PSP. GH is incorporated in the State of Delaware, USA and commenced operations in Dover, Tennessee on July 5, 2006.

## 2. BASIS OF PREPARATION

### (a) Statement of compliance

These condensed consolidated interim financial statements have been prepared in accordance with IAS 34 *Interim Financial Reporting.* They do not include all of the information required for full annual consolidated financial statements and should therefore be read in conjunction with the audited annual consolidated financial statements and notes thereto for the year ended June 30, 2015.

These condensed consolidated interim financial statements were authorized for issue by the Board of Directors on February 29, 2016.

All figures are presented in Canadian dollars unless otherwise noted.

### (b) Basis of measurement

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

### (c) Basis of consolidation

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

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

### (d) Use of estimates and judgments

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

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

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

## 2. BASIS OF PREPARATION (cont'd)

***(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)*** **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.

***(iii)*** **Trade and other receivables**

The Company uses historical trends and performs specific account assessments when determining the allowance for doubtful accounts. 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.

***(iv)*** **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. 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.

***(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 9. 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.

The estimate for the Company's provisions could change from period to period due to changes in historical trends, revenue or the business environment.

## 3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out in note 3 to the consolidated financial statements for the year ended June 30, 2015 have been applied consistently to all periods presented in these condensed consolidated interim financial statements.

## 4. FINANCE COSTS

| | Three months Ended December 31 2015 $ | Three Months Ended December 31 2014 $ | Six Months Ended December 31 2015 $ | Six Months Ended December 31 2014 $ |
|---|---|---|---|---|
| Interest on bank indebtedness | 3,205 | 7,467 | 4,326 | 17,847 |
| Interest on long term debt | 1,569 | 4,864 | 4,039 | 10,556 |
| Interest on debentures | 18,725 | 26,700 | 37,450 | 53,400 |
| Accretion of debentures | 3,166 | 18,940 | 5,720 | 43,322 |
| | 26,665 | 57,971 | 51,535 | 125,125 |

## 5. 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 | **49,114** | **—** | **4,682** | **1,351** | **55,147** |
| Effect of movements in exchange rates | **50,151** | **1,054** | **16,251** | **2,417** | **69,873** |
| **As at December 31, 2015** | **881,164** | **54,581** | **331,389** | **91,503** | **1,358,637** |
| | | | | | |
| **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 | **35,022** | **1,734** | **32,576** | **5,693** | **75,025** |
| Effect of movement in exchange rates | **32,554** | **806** | **12,783** | **1,490** | **47,633** |
| **As at December 31, 2015** | **623,835** | **42,651** | **266,965** | **59,489** | **992,940** |
| | | | | | |
| **Net book value** | | | | | |
| As at June 30, 2015 | 225,640 | 13,416 | 88,850 | 35,429 | 363,335 |
| **As at December 31, 2015** | **257,329** | **11,930** | **64,424** | **32,014** | **365,697** |

## 6. BANK INDEBTEDNESS

PSP has a Credit Agreement with a Canadian bank (the "Bank") for a credit facility in the amount of $900,000 moving to $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 1.95% 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 Funded Debt to EBITDA, calculated on a rolling 4 quarters basis for the fiscal quarter then ended and the immediately preceding 3 fiscal quarters, of not greater than 3:1. At December 30, 2015 and June 30, 2015, the amounts drawn on the credit facility were $210,000 and $160,000 respectively. As at December 30, 2015 PSP is in compliance with the covenant.

## 7. LONG-TERM DEBT

The Company's long-term debt consists of a secured term loan with interest payable monthly, calculated at the Lender's floating base rate on outstanding principal. The base rate was 4.7% as at December 31, 2015 and 5.0% at June 30, 2015. A variance rate of 2.3% will be added to the base rate if (i) consolidated financial statements are not submitted to the Lender within 6 months of each fiscal year end; (ii) available funds less non-financed capital expenditures in the most recent fiscal year are not at least 1.5 times the current portion of the long-term debt; or (iii) the debt to equity ratio of the Company exceeds 1.0:1. Debt is defined as long-term debt plus capital leases and book value of preferred shares subject to a formal redemption agreement. Principal is repayable in monthly instalments of $17,860, with the final payment occurring on May 23, 2016.

The term loan is secured by a first security interest in all present and after-acquired personal property, subject only to a prior charge with respect to receivables and inventory in favour of the bank providing a Canadian credit facility.

## 8. 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.

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. Interest expense is based on the effective interest method, with accretion expense of $5,720 recorded for the six months ended December 31, 2015.

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).

## 9. PROVISIONS

The provision for warranties is based on estimates made from historical data associated with similar products. At December 31, 2015 the warranty liability was $53,652 (June 30, 2015 - $51,283).

On August 16, 2011 the Company signed a sublease for the remaining lease term for its former head office premises in Kanata, Ontario. The Company recognized a provision for the discounted future lease payments to which the Company is committed less expected future sublease income in the amount of $122,308. The balance in the provision for onerous contracts at December 31, 2015 was $32,673 (June 30, 2015 - $43,684).

## 10. CAPITAL AND OTHER COMPONENTS OF EQUITY

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

| | December 31, 2015 | | June 30, 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.

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.

## 11. INCOME PER SHARE

Basic earnings per share amounts are calculated by dividing the net income for the period by the weighted-average common shares outstanding during the period. Diluted earnings per share amounts are calculated by dividing the net income for the period by the weighted-average common shares outstanding plus the weighted-average number of common shares that would be issued on conversion of all the dilutive potential common shares into common shares.

The following outstanding instruments had a dilutive effect for the three months ended December 31, 2015 and could have a dilutive effect in the future:

| | |
|---|---|
| Shares issuable on conversion of convertible debentures | **5,423,120** |
| Stock options | **4,135,000** |
| | **9,558,120** |

## 12. 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.

## 12. SHARE BASED PAYMENT(cont'd)

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. At December 31, 2015 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.

At December 31, 2015 the Company had 4,135,000 stock options outstanding with a weighted-average exercise price of $0.11 compared with 4,610,000 stock options outstanding with an exercise price of $0.11 at June 30, 2015.

| | Total<br>\# | Weighted average exercise price<br>$ |
|---|---|---|
| **Balance, June 30, 2015** | 4,610,000 | 0.11 |
| Exercised | **475,000** | **0.075** |
| **Balance, December 31, 2015** | **4,135,000** | **0.11** |

| | December 31, 2015 |
|---|---|
| **Total stock option pool authorized** | **6,640,319** |
| **Total stock option pool remaining** | **2,505,319** |

The following table summarizes information regarding the Company's stock options as at December 31, 2015:

| Options outstanding | | | | Options exercisable | |
|---|---|---|---|---|---|
| **Range of exercise prices**<br>$ | **Number outstanding** | **Weighted average remaining life (years)** | **Weighted average exercise price**<br>$ | **Number exercisable** | **Weighted average exercise price**<br>$ |
| 0.10 | 1,250,000 | 1.77 | 0.10 | 1,250,000 | 0.10 |
| 0.11 | 2,275,000 | 2.80 | 0.11 | 2,275,000 | 0.11 |
| 0.20 | 250,000 | 3.58 | 0.20 | 250,000 | 0.20 |
| 0.095 | 360,000 | 3.81 | 0.095 | 360,000 | 0.095 |
| **0.10** | **4,135,000** | **2.63** | **0.11** | **4,135,000** | **0.11** |

## 13. OPERATING SEGMENTS

The Company's principal business activity is the manufacture and sale of a comprehensive line of protective products and accessories for the defence and security market. The Company operates in Canada through PSP with operations based in Arnprior, Ontario, and in the U.S. through its GH subsidiary located in Dover, Tennessee. Head office expenses, including the office of the CEO and public company costs, are reported as Corporate.

These segments represent the Company's reportable segments which are used to manage the business. The Company analyzes the performance of its operating segments based on revenue growth and operating profitability.

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

## 13. OPERATING SEGMENTS (cont'd)

***For the three months ended December 31, 2015***

| | Canadian operations $ | U.S. operations $ | Corporate $ | Consolidated Total $ |
|---|---|---|---|---|
| Revenue | **2,153,726** | **2,306,750** | — | **4,460,476** |
| Elimination of inter-segment revenue | **(31,410)** | **(8,183)** | — | **(39,593)** |
| **Total revenue** | **2,122,316** | **2,298,567** | — | **4,420,883** |
| Gross margin | **599,139** | **342,553** | — | **941,692** |
| Expenses | **525,740** | **345,582** | **200,796** | **1,072,118** |
| Other items | **(157,725)** | **—** | **23,460** | **(134,265)** |
| Net earnings (loss) after taxes | **231,124** | **(3,029)** | **(224,256)** | **3,839** |

***For the three months end December 31, 2014***

| | Canadian operations $ | U.S. operations $ | Corporate $ | Consolidated total $ |
|---|---|---|---|---|
| Revenue | 2,207,210 | 1,379,505 | — | 3,586,715 |
| Elimination of inter-segment revenue | (18.802) | (51,975) | — | (70,777) |
| **Total revenue** | 2,188,408 | 1,327,530 | — | 3,515,938 |
| Gross margin | 690,649 | 276,753 | — | 967,402 |
| Expenses | 568,079 | 215,693 | 221,659 | 1,005,431 |
| Other items | 48,036 | — | — | 48,036 |
| Net earnings (loss) after taxes | 74,534 | 61,060 | (221,659) | (86,065) |

***For the six months ended December 31, 2015***

| | Canadian operations $ | U.S. operations $ | Corporate $ | Consolidated total $ |
|---|---|---|---|---|
| Revenue | **5,200,577** | **4,234,508** | — | **9,435,085** |
| Elimination of inter-segment revenue | **(42,844)** | **(10,114)** | — | **(52,958)** |
| **Total revenue** | **5,157,733** | **4,224,394** | — | **9,382,127** |
| Gross margin | **1,507,662** | **641,951** | — | **2,149,613** |
| Expenses | **1,092,939** | **593,564** | **380,211** | **2,066,714** |
| Other items | **(244,402)** | **—** | **47,209** | **(197,193)** |
| Net earnings (loss) after taxes | **659,125** | **48,387** | **(427,420)** | **280,092** |

## 13. OPERATING SEGMENTS (cont'd)

***For the six months end December 31, 2014***

| | Canadian operations $ | U.S. operations $ | Corporate $ | Consolidated total $ |
|---|---|---|---|---|
| Revenue | 4,341,064 | 3,049,710 | — | 7,390,774 |
| Elimination of inter-segment revenue | (52,964) | (89,707) | — | (142,671) |
| **Total revenue** | 4,288,100 | 2,960,003 | — | 7,248,103 |
| Gross margin | 1,269,697 | 767,579 | — | 2,037,276 |
| Expenses | 1,149,982 | 460,462 | 341,686 | 1,952,130 |
| Other items | 133,690 | — | — | 133,690 |
| Net earnings (loss) after taxes | (13,975) | 307,117 | (341,686) | (48,544) |

***As at December 31, 2015***

| | Canadian operations $ | U.S. operations $ | Corporate $ | Consolidated total $ |
|---|---|---|---|---|
| **Assets** | | | | |
| Current assets | **2,786,736** | **2,635,592** | **—** | **5,422,328** |
| Property and equipment | **147,352** | **218,345** | **—** | **365,697** |
| Prepaid deposits | **57,073** | **—** | **—** | **57,073** |
| | **2,991,161** | **2,853,937** | **—** | **5,845,098** |
| **Liabilities** | | | | |
| Current liabilities | **790,215** | **701,370** | **244,659** | **1,736,244** |
| Long-term debt | **—** | **—** | **703,399** | **703,399** |
| Long-term provisions | **34,777** | **19,413** | **—** | **54,190** |
| | **824,992** | **720,783** | **948,058** | **2,493,833** |

***As at June 30, 2015***

| | Canadian operations $ | U.S. operations $ | Corporate $ | Consolidated total $ |
|---|---|---|---|---|
| **Assets** | | | | |
| Current assets | 3,708,690 | 1,762,107 | — | 5,469,177 |
| Property and equipment | 154,033 | 209,302 | — | 363,335 |
| Prepaid deposits | 55,453 | — | — | 55,453 |
| | 3,918,176 | 1,971,409 | — | 5,889,585 |
| **Liabilities** | | | | |
| Current liabilities | 1,381,378 | 536,049 | 130,332 | 2,047,759 |
| Long-term debt | — | — | 693,157 | 693,157 |
| Long-term provisions | 45,788 | 17,517 | — | 63,305 |
| | 1,427,166 | 553,566 | 823,489 | 2,804,221 |

***Revenues for the six months ended December 31***

| | 2015 $ | 2014 $ |
|---|---|---|
| Canada | **5,069,808** | 4,288,100 |
| United States | **4,304,778** | 2,956,320 |
| International | **7,541** | 3,683 |
| | **9,382,127** | 7,248,103 |

## 13. OPERATING SEGMENTS (cont'd)

Revenues for the six months ended December 31, 2015 include $1.8 million from the Canadian Federal Government (six months ended December 31, 2014 - $1.7 million), which represents 19.2% (six months ended December 31, 2014 – 22.8%).

The Company had no other significant sales (over 10% of revenue) to any one customer.

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

## 14. RELATED PARTY TRANSACTIONS

Trade and other payables as of December 31, 2015 includes interest payable and directors fees payable to the directors and officers of $164,424 (June 30, 2015 - $119,799).

## 15. SUBSEQUENT EVENTS

On February 9, 2016 the Credit Agreement with a Canadian bank (the "Bank") for a credit facility was increased to the amount of $1.6 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.