



Pacific Safety Products Inc.

## REPORT TO SHAREHOLDERS

MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE  
NINE MONTHS ENDED MARCH 31, 2016 and 2015

## Management's Discussion and Analysis March 31, 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 May 30, 2016 and should be read together with the audited annual consolidated financial statements and the notes thereto for the three months ended March 31, 2016, and the audited annual consolidated financial statements and the notes thereto for the year ended June 30, 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](http://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](http://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 May 30, 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.

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# MANAGEMENT'S DISCUSSION AND ANALYSIS

## Mission

*...we bring everyday heroes home safely.™*

This MD&A is organized into the following parts:

- I. Business Overview and Recent Events
- II. Results
- III. Cash Flow
- IV. Liquidity and Capital Resources
- V. Quarterly Results
- VI. Significant Accounting Policies and Estimates
- VII. Risks and Uncertainties
- VIII. Other Information

## Part I: BUSINESS OVERVIEW AND RECENT EVENTS

### Business Overview

PSP is an established industry leader in the defence and security market. The Company is engaged in the design, production, 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 \$1.55 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 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

<b>SUMMARY OF OPERATIONS</b>	THREE MONTHS	THREE MONTHS	NINE MONTHS	NINE MONTHS
	ENDED MARCH 31, 2016	ENDED MARCH 31, 2015	ENDED MARCH 31, 2016	ENDED MARCH 31, 2015
REVENUES	\$ 5,233,746	\$ 5,003,565	\$ 14,615,873	\$ 12,251,668
COST OF SALES	3,917,321	3,637,171	11,149,835	8,847,998
GROSS MARGIN	1,316,425	1,366,394	3,466,038	3,403,670
EXPENSES	1,191,595	1,130,838	3,258,309	3,082,968
INCOME BEFORE OTHER ITEMS	124,830	235,556	207,729	320,702
OTHER ITEMS	120,500	156,561	(76,693)	290,251
INCOME BEFORE INCOME TAXES	4,330	78,995	284,422	30,451
INCOME TAXES	—	—	—	—
NET INCOME FOR THE PERIOD	\$ 4,330	\$ 78,995	\$ 284,422	\$ 30,451
OTHER COMPREHENSIVE INCOME (LOSS)	(292)	73,527	(50,233)	125,772
TOTAL COMPREHENSIVE INCOME FOR THE PERIOD	4,038	152,522	234,189	156,223
INCOME PER SHARE -				
BASIC	\$ -	\$ -	\$ -	\$ -
DILLUTED	\$ -	\$ -	\$ -	\$ -

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

	THREE MONTHS	THREE MONTHS	NINE MONTHS	NINE MONTHS
	ENDED MARCH 31, 2016	ENDED MARCH 31, 2015	ENDED MARCH 31, 2016	ENDED MARCH 31, 2015
NET INCOME FOR THE PERIOD	\$ 4,330	\$ 78,995	\$ 284,422	\$ 30,451
FINANCE COSTS, NET	22,698	36,018	73,919	148,763
DEPRECIATION AND AMORTIZATION	40,568	21,267	116,433	107,894
EBITDA	\$ 67,596	\$ 136,280	\$ 474,774	\$ 287,108
FOREIGN EXCHANGE (GAIN) LOSS	97,802	115,977	(150,612)	136,922
SHARE BASED COMPENSATION	-	-	-	5,000
ADJUSTED EBITDA	\$ 165,398	\$ 252,257	\$ 324,162	\$ 429,030

<b>FINANCIAL POSITION</b>	AS AT MARCH 31, 2016	AS AT JUNE 30, 2015
TOTAL ASSETS	\$ 5,820,381	\$ 5,889,585
TOTAL LONG-TERM FINANCIAL LIABILITIES	\$ 756,254	\$ 756,462

## **Revenues**

Revenues for the three months ended March 31, 2016 were \$5.2 million, an increase of \$0.2 million or 4.6% as compared with the same period in the prior year. Revenues from Canadian customers for the three months ended March 31, 2016 were \$2.4 million, a decrease of \$1.3 million or 35.1% compared to the same period in the prior year. Revenues from U.S. and International customers for the three months ended March 31, 2016 were \$2.8 million, an increase of \$1.5 million or 115.4% 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 nine months ended March 31, 2016 were \$14.6 million, an increase of \$2.4 million or 19.3% as compared with the same period in the prior year. Revenues from Canadian customers for the nine months ended March 31, 2016 were \$7.6 million, a decrease of \$0.5 million or 6.2% compared to the same period in the prior year. The decrease relates primarily to the timing of orders for key contracts. Revenues from U.S. and International customers for the nine months ended March 31, 2016 were \$7.0 million, an increase of \$2.8 million or 66.7% 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 March 31, 2016, gross margin as a percentage of revenues was 25.2%, a decrease of 2.1% compared with the same period in the prior year. The decrease relates to the mix of higher US sales which normally carry a lower margins compared to Canada sales.

For the nine months ended March 31, 2016, gross margin as a percentage of revenues was 23.7%, a decrease of 4.1% 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 nine months ended March 31, 2016, 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 \$0.2 million increase in sales and marketing related to the increase in U.S. sales.

## **Foreign exchange losses (gains)**

For the nine months ended March 31, 2016, foreign exchange gain was \$0.15 million as compared to a loss of \$0.14 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 nine months ended March 31, 2016, finance costs were \$0.07 million a decrease of \$0.09 million compared with the same period in the prior year. Significant improvements in working capital led to a lower average outstanding balance on the line of credit and more favourable interest rates on longer-term notes.

## **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 March 31, 2016, the Company recorded a net income of \$0.004 million as compared to a net income of \$0.08 million in the prior year. The decrease in income was primarily related to increased sale and marketing cost on U.S. sales as compared with the same period in the prior year.

For the nine months ended March 31, 2016, the Company recorded a net income of \$0.29 million as compared to a net income of \$0.03 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 March 31, 2016, the Company recorded other comprehensive loss of \$0.0 million compared to a gain of \$0.07 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 nine months ended March 31, 2016, the Company recorded other comprehensive loss of \$0.05 million compared to income of \$0.125 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 March 31, 2016 Adjusted EBITDA was \$0.17 million compared to an Adjusted EBITDA of \$0.25 million during the same period in the prior year.

For the nine months ended March 31, 2016 Adjusted EBITDA was \$0.33 million compared to an Adjusted EBITDA of \$0.43 million during the same period in the prior year.

### **Part III: CASH FLOW**

<b><u>CASH FLOW FROM (USED IN)</u></b>	<b><u>NINE MONTHS ENDED MARCH 31, 2016</u></b>	<b><u>NINE MONTHS ENDED MARCH 31, 2015</u></b>
Operating activities	\$ 380,535	\$ (1,033,729)
Investing activities	(93,185)	(83,896)
Financing activities	(284,990)	460,645
Increase (decrease) in cash and cash equivalents, net of bank overdraft used for cash management purposes	\$ 2,360	\$ (656,980)

Cash flow from operating activities for the nine months ended March 31, 2016 was \$0.4 million as compared to cash flows used in operating activities of \$1.0 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 nine months ended March, 2016 was \$0.09 million as compared to \$0.08 million during the same period in the prior year.

Cash flow used in financing activities for the nine months ended March 31, 2016 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**

<b><u>AS AT</u></b>	<b><u>MARCH 31, 2016</u></b>	<b><u>JUNE 30, 2015</u></b>
Cash and cash equivalents	\$ 199,438	\$ 128,255
Bank indebtedness	-	(160,000)
Working capital	3,703,983	3,421,418
Long-term debt (long-term portion only)	(708,744)	(693,157)
Shareholders' equity	(3,355,303)	(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.

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 March 31, 2016, 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 \$0.3 million, an increase in inventory of \$0.1 million, a decrease in trade and other payables of \$0.1 million and a net increase in cash and cash equivalents of \$0.07 million with the net decrease in the new operating line of \$0.16 million.

Accounts receivable as at March 31, 2016 were \$3.1 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 March 31, 2016 compared to the three months ended June 30, 2015 and the timing of collection of those revenues.

Inventory as at March 31, 2016 increased by \$0.05 million to \$1.9 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 March 31, 2016 were \$1.5 million compared to \$1.6 million as at June 30, 2015. The slight decrease reflects 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 March 31, 2016 and June 30, 2015, the amounts drawn on the credit facility were Nil and \$160,000 respectively. As at March 31, 2016 PSP is in compliance with the 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% to 4.75%. At March 31, 2016, the principal outstanding on the loan was \$0.03 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 \$8,804 recorded for the nine months ended March 31, 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 March 31, 2016 the Company has cumulative non-capital losses available to be carried forward in the following jurisdictions: Canada - \$4,164,000 United States - \$7,082,000. 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 March 30, 2016 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 March 31, 2016, 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**

<b>Fiscal 2016</b>		<b>March 31, 2016</b>	<b>December 31, 2015</b>	<b>September 30, 2015</b>
<b>Revenues</b>		<b>\$ 5,233,746</b>	<b>\$ 4,420,883</b>	<b>\$ 4,961,244</b>
<b>Net income for the period</b>		<b>4,330</b>	<b>3,839</b>	<b>276,253</b>
<b>Basic and diluted earnings per share</b>		<b>-</b>	<b>-</b>	<b>-</b>
<b>Fiscal 2015</b>	<b>June 30, 2015</b>	<b>March 31, 2015</b>	<b>December 31, 2014</b>	<b>September 30, 2014</b>
Revenues	\$ 5,477,187	\$ 5,003,565	\$ 3,515,938	\$ 3,732,165
Net income (loss) for the period	986,481	78,995	(86,065)	37,521
Basic and diluted earnings (loss) per share	0.02	-	-	-
<b>Fiscal 2014</b>	<b>June 30, 2014</b>	<b>March 31, 2014</b>	<b>December 31, 2013</b>	<b>September 30, 2013</b>
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 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 \$0.004 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.

## **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 March 31, 2016, the trade and other receivables line represented 53% 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 March 31, 2016, the inventory line represented 35% 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.

Condensed Consolidated Interim Financial Statements of

**PACIFIC SAFETY PRODUCTS INC.**

Nine months ended March 31, 2016 and 2015

(Unaudited)

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

FOR THE NINE MONTHS ENDED MARCH 31, 2016 and 2015

### 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

May 30, 2016

Pacific Safety Products Inc.

**CONDENSED CONSOLIDATED INTERIM STATEMENT OF FINANCIAL POSITION**

(Unaudited)

	March 31, 2016 \$	June 30, 2015 \$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	199,438	128,255
Trade and other receivables	3,076,601	3,403,027
Inventories	2,028,047	1,882,442
Prepaid expenses	153,723	55,453
<b>Total current assets</b>	<b>5,457,809</b>	<b>5,469,177</b>
Property and equipment <i>[note 5]</i>	305,499	363,335
Prepaid deposits	57,073	57,073
	<b>5,820,381</b>	<b>5,889,585</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Bank indebtedness <i>[notes 6]</i>	—	160,000
Trade and other payables	1,646,537	1,587,458
Short-term provisions <i>[note 9]</i>	31,836	31,662
Deferred revenue	39,731	72,179
Current portion of long-term debt <i>[note 7]</i>	35,720	196,460
<b>Total current liabilities</b>	<b>1,753,824</b>	<b>2,047,759</b>
Long-term provisions <i>[note 9]</i>	47,510	63,305
Convertible debentures <i>[note 8]</i>	708,744	693,157
	<b>2,510,078</b>	<b>2,804,221</b>
<b>Shareholders' equity</b>		
Share capital <i>[note 10]</i>	20,590,066	20,554,316
Contributed surplus	2,075,652	2,075,652
Other paid-in capital	269,563	269,563
Deficit	(19,570,442)	(19,854,864)
Accumulated other comprehensive loss	(9,536)	40,697
<b>Total shareholders' equity</b>	<b>3,355,303</b>	<b>3,085,364</b>
	<b>5,865,381</b>	<b>5,889,585</b>

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

Pacific Safety Products Inc.

**CONDENSED CONSOLIDATED INTERIM STATEMENT OF INCOME  
AND COMPREHENSIVE INCOME**

(Unaudited)

For the three and nine month periods ended March 31, 2016 and 2015

	<b>Three Months ended March 31, 2016 \$</b>	Three Months ended March 31, 2015 \$	<b>Nine Months ended March 31, 2016 \$</b>	Nine Months ended March 31, 2015 \$
<b>Revenue</b>	<b>5,233,746</b>	5,003,565	<b>14,615,873</b>	12,251,668
Cost of sales	<b>3,917,321</b>	3,637,171	<b>11,149,835</b>	8,847,998
<b>Gross margin</b>	<b>1,316,425</b>	1,366,394	<b>3,466,038</b>	3,403,670
<b>Expenses</b>				
Sales and marketing	<b>534,894</b>	446,987	<b>1,329,492</b>	1,133,260
Research and development	<b>261,108</b>	250,954	<b>622,003</b>	714,328
General and administration	<b>395,593</b>	432,897	<b>1,306,814</b>	1,235,380
<b>Total expenses</b>	<b>1,191,595</b>	1,130,838	<b>3,258,309</b>	3,082,968
Income before other items	<b>124,830</b>	235,556	<b>207,729</b>	320,702
<b>Other items</b>				
Foreign exchange (gain) loss	<b>97,802</b>	115,977	<b>(150,612)</b>	136,922
Finance income	<b>(1,670)</b>	(233)	<b>(1,984)</b>	(12,613)
Finance costs [note 4]	<b>24,368</b>	36,251	<b>75,903</b>	161,376
Loss on disposal of assets	—	4,566	—	4,566
<b>Total other items</b>	<b>120,500</b>	156,561	<b>(76,693)</b>	290,251
Income before income taxes	<b>4,330</b>	78,995	<b>284,422</b>	30,451
<b>Income taxes</b>				
Current income tax recovery	—	—	—	—
<b>Net Income for the period</b>	<b>4,330</b>	78,995	<b>284,422</b>	30,451
<b>Other comprehensive income (loss), net of tax, that is subject to reclassification to net income</b>				
Foreign currency translation differences – foreign operations	<b>(292)</b>	73,527	<b>(50,233)</b>	125,772
<b>Total comprehensive income for the period</b>	<b>4,038</b>	152,522	<b>234,189</b>	156,223
<b>Income per share [note 12]</b>				
Basic and diluted	—	—	—	—
<b>Weighted average common shares issued and outstanding</b>				
Basic and diluted	<b>66,403,189</b>	65,689,267	<b>66,225,278</b>	65,570,216

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 nine months ended March 31, 2016 and 2015

	Share Capital	Contributed surplus	Other paid-in capital	Deficit	Cumulative translation account	Total
	\$	\$	\$	\$	\$	\$
<b>Balance, July 1, 2014</b>	20,514,316	2,062,802	234,953	(20,871,796)	(82,440)	1,857,835
Net loss for the period	—	—	—	30,451	—	30,451
Other comprehensive income						
Foreign currency translation differences	—	—	—	—	125,772	125,772
<b>Total comprehensive income</b>	—	—	—	30,451	125,772	156,223
Issuance of shares	20,000	—	—	—	—	20,000
Share options exercised	2,500	—	—	—	—	2,500
Convertible debenture	—	—	34,610	—	—	34,610
Share-based compensation expense	—	12,850	—	—	—	12,850
Total amounts attributable to owners	22,500	12,850	34,610	—	—	69,960
<b>Balance, March 31, 2015</b>	20,536,816	2,075,652	269,563	(20,841,345)	43,332	2,084,018
<b>Balance, July 1, 2015</b>	20,554,316	2,075,652	269,563	(19,854,864)	40,697	3,085,364
Net Income for the period	—	—	—	284,422	—	284,422
Other comprehensive income						
Foreign currency translation differences	—	—	—	—	(50,233)	(50,233)
<b>Total comprehensive income (loss)</b>	—	—	—	284,422	(50,233)	234,189
Issuance of shares	35,750	—	—	—	—	35,750
Total amounts attributable to owners	35,750	—	—	—	—	35,750
<b>Balance, March 31, 2016</b>	20,590,066	2,075,652	269,563	(19,570,442)	(9,536)	3,355,303

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 nine months ended March 31, 2016 and 2015

	<b>Nine Months ended March 31, 2016 \$</b>	Nine Months ended March 31, 2015 \$
<b>OPERATING ACTIVITIES</b>		
Cash receipts from customers	<b>16,178,255</b>	11,064,226
Cash paid to suppliers and employees	<b>(15,715,747)</b>	(11,939,597)
Interest paid	<b>(83,958)</b>	(170,971)
Interest received	<b>1,985</b>	12,613
<b>Cash provided by (used in) operating activities</b>	<b>380,535</b>	<b>(1,033,729)</b>
<b>INVESTING ACTIVITY</b>		
Purchase of property and equipment	<b>(93,185)</b>	(88,463)
Loss on disposal of property and equipment	<b>—</b>	4,567
<b>Cash used in investing activity</b>	<b>(93,185)</b>	<b>(83,896)</b>
<b>FINANCING ACTIVITY</b>		
Proceeds from exercise of stock options	<b>35,750</b>	—
Issuance cost on debentures	<b>—</b>	(28,501)
Proceeds from new debentures	<b>—</b>	689,886
Repayment of debentures	<b>—</b>	(890,000)
Repayment of GIC	<b>—</b>	1,040,000
Change in Overdraft Line of Credit	<b>(160,000)</b>	(190,000)
Repayment of long-term debt	<b>(160,740)</b>	(160,740)
<b>Cash (used in) provided by financing activity</b>	<b>(284,990)</b>	<b>460,645</b>
<b>Net increase (decrease) in cash and cash equivalents during the period</b>	<b>2,360</b>	<b>(656,980)</b>
Cash and cash equivalents, beginning of period	<b>128,255</b>	680,335
Effect of exchange rate fluctuations on cash held	<b>68,823</b>	115,860
<b>Cash and cash equivalents, (net of bank indebtedness) ending [note 5]</b>	<b>199,438</b>	<b>139,215</b>

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



**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**  
(Unaudited)

FOR THE NINE MONTHS ENDED MARCH 31, 2016 and 2015

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**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 9 months ended March 31, 2016 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 May 30, 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.

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

FOR THE NINE MONTHS ENDED MARCH 31, 2016 and 2015

**4. FINANCE COSTS**

	Three months Ended March 31, 2016 \$	Three Months Ended March 31, 2015 \$	Nine Months Ended March 31, 2016 \$	Nine Months Ended March 31, 2015 \$
Interest on bank indebtedness	970	2,368	5,296	20,215
Interest on long-term debt	1,589	4,000	5,628	14,556
Interest on debentures	18,725	21,997	56,175	75,397
Accretion of debentures	3,084	7,886	8,804	51,208
	<b>24,368</b>	<b>36,251</b>	<b>75,903</b>	<b>161,376</b>

**5. PROPERTY AND EQUIPMENT**

	Manufacturing equipment \$	Office equipment \$	Leasehold improvements \$	Computer equipment \$	Total \$
<b>Cost</b>					
<b>As at June 30, 2014</b>	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
<b>As at June 30, 2015</b>	<b>781,899</b>	<b>53,527</b>	<b>310,456</b>	<b>87,735</b>	<b>1,233,617</b>
Additions	49,114	2,110	38,830	2,924	92,978
Effect of movements in exchange rates	17,941	388	5,427	878	24,634
<b>As at March 31, 2016</b>	<b>848,954</b>	<b>56,025</b>	<b>354,713</b>	<b>91,537</b>	<b>1,351,229</b>
<b>As at June 30, 2014</b>	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
<b>As at June 30, 2015</b>	<b>556,259</b>	<b>40,111</b>	<b>221,606</b>	<b>52,306</b>	<b>870,282</b>
Depreciation	54,085	2,690	50,682	8,660	116,117
Effect of movement in exchange rates	10,438	246	3,194	453	14,331
<b>As at March 31, 2016</b>	<b>620,782</b>	<b>43,047</b>	<b>275,482</b>	<b>61,419</b>	<b>1,000,730</b>
<b>Net book value</b>					
As at June 30, 2015	225,640	13,416	88,850	35,429	363,335
<b>As at March 31, 2016</b>	<b>228,172</b>	<b>12,978</b>	<b>79,231</b>	<b>30,118</b>	<b>350,499</b>

## 6. 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 March 31, 2016 and June 30, 2015, the amounts drawn on the credit facility were Nil and \$160,000 respectively. As at March 31, 2016 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 March 31, 2016 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 \$8,804 recorded for the nine months ended March 31, 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).

## 9. PROVISIONS

The provision for warranties is based on estimates made from historical data associated with similar products. At March 31, 2016 the warranty liability was \$52,155 (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 March 31, 2016 was \$27,191 (June 30, 2015 - \$43,684).

**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**  
(Unaudited)

FOR THE NINE MONTHS ENDED MARCH 31, 2016 and 2015

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**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.

	March 31, 2016		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
<b>Balance, end of period</b>	<b>66,403,189</b>	<b>20,590,066</b>	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 March 31, 2016 and could have a dilutive effect in the future:

Shares issuable on conversion of convertible debentures	5,050,793
Stock options	4,060,000
	<u>9,110,793</u>

**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.

**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**  
(Unaudited)

FOR THE NINE MONTHS ENDED MARCH 31, 2016 and 2015

**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 March 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 March 31, 2016 the Company had 4,060,000 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 #	Weighted average exercise price \$
<b>Balance, June 30, 2015</b>	4,610,000	0.11
Exercised	<b>475,000</b>	<b>0.075</b>
Expired	<b>75,000</b>	<b>0.11</b>
<b>Balance, March 31, 2016</b>	<b>4,060,000</b>	<b>0.11</b>
		<b>March 31, 2016</b>
<b>Total stock option pool authorized</b>		<b>6,640,319</b>
<b>Total stock option pool remaining</b>		<b>2,580,319</b>

The following table summarizes information regarding the Company's stock options as at March 31, 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	1.52	0.10	1,250,000	0.10
0.11	2,200,000	2.65	0.11	2,200,000	0.11
0.20	250,000	3.33	0.20	250,000	0.20
0.095	360,000	3.56	0.095	360,000	0.095
<b>0.11</b>	<b>4,060,000</b>	<b>2.42</b>	<b>0.11</b>	<b>4,060,000</b>	<b>0.11</b>

**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.

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**13. OPERATING SEGMENTS (cont'd)**

*For the three months ended March 31, 2016*

	Canadian operations \$	U.S. operations \$	Corporate \$	Consolidated Total \$
Revenue	2,500,135	2,865,508	—	5,365,643
Elimination of inter-segment revenue	(100,482)	(31,415)	—	(131,897)
<b>Total revenue</b>	<b>2,399,653</b>	<b>2,834,093</b>	<b>—</b>	<b>5,233,746</b>
Gross margin	558,495	757,930	—	1,316,425
Expenses	551,910	506,404	133,281	1,191,595
Other items	99,216	—	21,284	120,500
Net earnings (loss) after taxes	(92,631)	251,526	(154,565)	4,330

*For the three months ended March 31, 2015*

	Canadian operations \$	U.S. operations \$	Corporate \$	Consolidated total \$
Revenue	3,749,741	1,454,237	—	5,203,978
Elimination of inter-segment revenue	(31,752)	(168,661)	—	(200,413)
<b>Total revenue</b>	<b>3,717,989</b>	<b>1,285,576</b>	<b>—</b>	<b>5,003,565</b>
Gross margin	1,100,951	265,443	—	1,366,394
Expenses	636,438	295,096	199,304	1,130,838
Other items	128,196	—	28,365	156,561
Net earnings (loss) after taxes	336,317	(29,653)	(227,669)	78,995

*For the nine months ended March 31, 2016*

	Canadian operations \$	U.S. operations \$	Corporate \$	Consolidated total \$
Revenue	7,717,955	7,100,016	—	14,817,971
Elimination of inter-segment revenue	(160,569)	(41,529)	—	(202,098)
<b>Total revenue</b>	<b>7,557,386</b>	<b>7,058,487</b>	<b>—</b>	<b>14,615,873</b>
Gross margin	2,066,157	1,399,881	—	3,466,038
Expenses	1,644,849	1,099,968	513,492	3,258,309
Other items	(145,186)	—	68,493	(76,693)
Net earnings (loss) after taxes	566,494	299,913	(581,985)	284,422

Pacific Safety Products Inc.  
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**13. OPERATING SEGMENTS (cont'd)**

*For the nine months ended March 31, 2015*

	Canadian operations \$	U.S. operations \$	Corporate \$	Consolidated total \$
Revenue	8,093,341	4,503,947	—	12,597,288
Elimination of inter-segment revenue	(87,252)	(258,368)	—	(345,620)
<b>Total revenue</b>	<b>8,006,089</b>	<b>4,245,579</b>	<b>—</b>	<b>12,251,668</b>
Gross margin	2,370,648	1,033,022	—	3,403,670
Expenses	1,738,632	755,558	588,778	3,082,968
Other items	154,609	—	135,642	290,251
Net earnings (loss) after taxes	477,407	277,464	(724,420)	30,451

*As at March 31, 2016*

	Canadian operations \$	U.S. operations \$	Corporate \$	Consolidated total \$
<b>Assets</b>				
Current assets	2,504,258	2,953,555	—	5,457,813
Property and equipment	164,583	185,916	—	350,499
Prepaid deposits	57,073	—	—	57,073
	<b>2,725,914</b>	<b>3,139,471</b>	<b>—</b>	<b>5,865,385</b>
<b>Liabilities</b>				
Current liabilities	850,386	758,552	144,886	1,753,824
Long-term debt	—	—	708,744	708,744
Long-term provisions	29,295	18,215	—	47,510
	<b>879,681</b>	<b>776,767</b>	<b>853,630</b>	<b>2,510,078</b>

*As at June 30, 2015*

	Canadian operations \$	U.S. operations \$	Corporate \$	Consolidated total \$
<b>Assets</b>				
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
	<b>3,918,176</b>	<b>1,971,409</b>	<b>—</b>	<b>5,889,585</b>
<b>Liabilities</b>				
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
	<b>1,427,166</b>	<b>553,566</b>	<b>823,489</b>	<b>2,804,221</b>

*Revenues for the nine months ended March 31*

	2016 \$	2015 \$
Canada	7,557,386	8,006,089
United States	6,976,785	4,172,550
International	81,702	73,029
	<b>14,615,873</b>	<b>12,251,668</b>



**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**  
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**13. OPERATING SEGMENTS (cont'd)**

Revenues for the nine months ended March 31, 2016 include \$2.6 million from the Canadian Federal Government (March 31, 2015 - \$3.1 million), which represents 17.9% (March 31, 2015 – 25.1%).

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 March 31, 2016 includes interest payable and directors fees payable to the directors and officers of \$118,786 (June 30, 2015 - \$119,799).