Annual Report

September 30, 2017

NANOTECH
SECURITY CORP.

For purposes of this management discussion and analysis ("MD&A"), "Nanotech", the "Company", "we", or "us" refers to Nanotech Security Corp. and its subsidiaries. This year and 2017 mean the fiscal year ended September 30, 2017. Last year and 2016 mean the fiscal year ended September 30, 2016, and 2015 means the fiscal year ended September 30, 2015. This quarter means the three months ended September 30, 2017.

ADVISORY

This MD&A, dated December 19, 2017, should be read in conjunction with the cautionary statement regarding forward-looking statements below and the Company's Consolidated Financial Statements for the year ended September 30, 2017. The results reported herein have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") and are presented in Canadian dollars. All quarterly information disclosed in the MD&A is unaudited.

Additional information relating to the Company is filed on SEDAR at www.sedar.com.

FORWARD-LOOKING STATEMENTS

The following discussion and analysis of the financial conditions and results of operations contains forward-looking statements concerning anticipated developments in the Company's operations in future periods, the adequacy of Nanotech's financial resources, and the events or conditions that may occur in the future. Forward-looking statements are frequently, but not always, identified by words such as "expects", "anticipates", "believes", "intends", "estimates", "predicts", "potential", "targeted" "plans", "possible" and similar expressions, or statements that events, conditions, or results "will", "may", "could" or "should" occur or be achieved.

These forward-looking statements include, without limitation, statements about the Company's market opportunities, strategies, competition, and the Company's views that its optics based technologies will continue to show promise for large scale production. Other forward-looking statements imply that the Company will remain capable of being financed and/or will be able to partner development until profitability is eventually realized. The principal risks related to these forward-looking statements are that the Company's products receive market acceptance, that its intellectual property claims will be sufficiently broad or enforceable to provide the necessary protection or attract the necessary capital.

These forward-looking statements are based on the beliefs, expectations and opinions of management on the date the statements are made. Consequently, all forward-looking statements made in this discussion and analysis of the financial conditions and results of operations or the documents incorporated by reference, are qualified by this cautionary statement and there can be no certainty that actual results or developments the Company anticipates will be realized. For additional information with respect to certain of these risks or factors reference should be made to the "Business Risks and Uncertainties" section of this MD&A and notes to the Consolidated Financial Statements, as well as with the Company's continuous disclosure materials filed from time to time with Canadian securities regulatory authorities, which are available online at www.sedar.com. Nanotech disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than as required by law. Caution needs to be used when taking forward-looking statements into account when evaluating the Company.

GENERAL OVERVIEW

Nanotech is incorporated under the laws of British Columbia, is listed on the TSX Venture Exchange (trading symbol: NTS) and quoted in the United States on the OTCQX Market (trading symbol: NTSFF). The Company's head office is located at #505 - 3292 Production Way, Burnaby, BC, Canada V5A 4R4. The Company's registered and records office is #1500 - 1055 West Georgia, Vancouver, BC, Canada V6E 4N7.

Nanotech designs, manufactures and markets nano-optic products that have brand protection and enhancement applications across a wide range of markets including banknotes, tax stamps, secure government documents, commercial branding, and the pharmaceutical industry.

The Company's KolourOptik® technology employs arrays of billions of nano-indentations that are impressed or embossed onto a substrate material such as polymer, paper, metal, or fabric. By using sophisticated algorithms to direct an electron beam, the Company creates visual images with colour-shifting effects such as 3D, perceived movement, and can also display high-definition colours including skin tones, and whites and blacks, which are not possible using holographic technology.

The Company's optical thin film ("OTF") security features are manufactured using precision engineered nanometer thick layers of metals and ceramics to form filters designed to uniquely manipulate visible and non-visible light. This unique manipulation of light properties is used to create specialized security features in the form of threads, stripes and patches that are applied to banknotes and other secure documents. By using sophisticated electron beam and sputtered deposition methods, Nanotech precisely controls the construction and inherent properties to provide custom tailored colour-shifting solutions. An individual looking at these threads, stripes and patches sees an obvious colour-shift (e.g. green to magenta) when it is tilted or rotated.

On September 21, 2017, the Directors of the Company made the determination that it would pursue the possible sale of its subsidiary Tactical Technologies Inc. ("Tactical") to a third party. The Company is actively pursuing potential purchasers and has engaged a business broker to pursue interested parties. At September 30, 2017, Tactical was classified as a separate disposal group held for sale and as a discontinued operation. Accordingly, the Company's Comparative Consolidated Statements of Operation have been restated to exclude the discontinued operations.

RESULTS OF OPERATIONS

Select financial information for the years ended September 30, 2017, 2016 and 2015:

Select Financial Information	2017	2016	2015
Revenue	$ 7,343,791	$ 2,888,896	$ 3,098,322
Cost of sales	1,429,371	884,132	1,397,618
	5,914,420	2,004,764	1,700,704
Expenses			
Research and development	1,475,437	1,996,715	980,070
General and administration	2,308,846	2,307,368	2,949,681
Sales and marketing	2,043,514	2,078,612	1,569,912
Depreciation and amortization	2,755,882	3,010,263	2,188,460
	8,583,679	9,392,958	7,688,123
Loss from continuing operations before other expenses	(2,669,259)	(7,388,194)	(5,987,419)
Other expenses (income)	1,184,594	433,513	(1,450,826)
Loss from continuing operations before income taxes	(3,853,853)	(7,821,707)	(4,536,593)
Deferred income tax recovery	-	162,797	-
Net loss from continuing operations	(3,853,853)	(7,658,910)	(4,536,593)
Loss from discontinued operations	(900,279)	(170,895)	(134,240)
Net loss	$ (4,754,132)	$ (7,829,805)	$ (4,670,833)
Adjusted EBITDA[1]	$ 1,168,222	$ (3,648,411)	$ (2,962,431)

[1]Adjusted EBITDA is a non-IFRS measure as described in the Non-IFRS Financial Measures section of this MD&A.

Financial Position as at September 30,	2017	2016	2015
Cash	$ 10,883,919	$ 3,312,691	$ 3,021,928
Total debt	-	6,595,142	3,000,000
	$ 10,883,919	$ (3,282,451)	$ 21,928
Total assets	$ 30,059,624	$ 24,511,586	$ 27,783,859
Total liabilities	1,860,086	8,089,503	4,858,986
Total equity	28,199,538	16,422,083	22,924,873

Revenue

Revenues for the year ended September 30, 2017 increased by $4,454,895 or 154% to $7,343,791, compared to $2,888,896 in the same period last year. Revenue growth was primarily due to increased revenue from paid development contracts, and an increase in OTF revenue from our Thurso facility. During the year, the Company disclosed a development contract for up to $30.0 million over a period of up to five years. These development activities incorporate both nano-optic and OTF technologies and are focused on developing authentication features for future banknotes.

Gross Margin

Gross margin for the year ended September 30, 2017 increased by $3,909,656 or 195% to $5,914,420, compared to $2,004,764 in the same period last year. Overall, the gross margin percentage improved to 81% for the year ended September 30, 2017, an increase from 69% in the same period last year. Gross margins continue to reflect strong margins from both development contracts and OTF deliveries.

Research and Development

Research and development expenditures for the year ended September 30, 2017 decreased by $521,278, or 26% to $1,475,437 compared to $1,996,715 in the same period last year, due to a larger portion of salaries and other expenses being allocated to cost of sales for increased development projects activities.

General and Administration

General and administration expenditures for the year ended September 30, 2017 were $2,308,846, an increase of $1,478, consistent with the same period last year.

Sales and Marketing

Sales and marketing expenditures for the year ended September 30, 2017 were $2,043,514, a decrease of $35,098 or 2% compared to $2,078,612 in the same period last year. The decrease mainly relates to a reduction in travel and marketing expenses.

Depreciation and Amortization

Depreciation and amortization included in operating expenditures for the year ended September 30, 2017 was $2,755,882, compared to $3,010,263 in the same period last year. Depreciation included in cost of sales for the year ended September 30, 2017 was $160,401 compared to $67,734 for the same period last year. The reduction in depreciation and amortization expenditures reflects the Company's declining balance depreciation policy and fewer fixed asset additions.

As of September 30, 2107, the Company has fully amortized its intangible assets, which will result in a reduction in annual amortization of $1,361,239 going forward.

Other Expenses

Other expenses for the year ended September 30, 2017 were $1,184,594, an increase of $751,081 compared to $433,513 in the same period last year. The 2017 results contain $1,014,779 of interest expense including, $589,858 of accretion that was a result of the Company's decision to repay the convertible debentures and an increase in foreign exchange loss during the year.

Adjusted EBITDA

Adjusted EBITDA for the year ended September 30, 2017 was $1,168,222, compared to negative $3,648,411 during the same period last year. The improvement reflects an increase in revenues, reduced expenses, and higher margins.

Net Loss

Net loss for the year ended September 30, 2017 was $4,754,132, compared to $7,829,805 during the same period last year. The decrease in net loss also reflects an increase in revenues, higher margins, and lower expenses.

QUARTERLY RESULTS

	Q4 2017	Q3 2017	Q2 2017	Q1 2017	Q4 2016	Q3 2016	Q2 2016	Q1 2016
($ thousands, except common share amounts)								
Revenue	$ 2,662	$ 2,569	$ 1,419	$ 694	$ 1,177	$ 497	$ 645	$ 570
Income (loss) from continuing operations	127	(749)	(1,559)	(1,673)	(1,566)	(1,976)	(2,280)	(1,837)
Net loss	(301)	(905)	(1,695)	(1,853)	(1,677)	(1,957)	(2,450)	(1,746)
Adjusted EBITDA(1)	1,132	858	(268)	(554)	(444)	(1,088)	(1,091)	(1,025)
Basic earnings (loss) per share:								
Continuing operations	0.00	(0.01)	(0.03)	(0.03)	(0.03)	(0.04)	(0.04)	(0.03)
Net loss	0.00	(0.02)	(0.03)	(0.03)	(0.03)	(0.04)	(0.05)	(0.03)
Diluted earnings (loss) per share:								
Continuing operations	0.00	(0.01)	(0.03)	(0.03)	(0.03)	(0.04)	(0.04)	(0.03)
Net loss	0.00	(0.02)	(0.03)	(0.03)	(0.03)	(0.04)	(0.05)	(0.03)

(1)Adjusted EBITDA is a non-IFRS measure as described in the Non-IFRS Financial Measures section of this MD&A.

There are no seasonal effects or other trends in the Company's business over the quarters presented.

RELATED PARTY TRANSACTIONS

For the year ended September 30, 2017, the Company had no transactions with related parties as defined in IAS 24, Related Party Disclosures, except those pertaining to transactions with key management personnel in the ordinary course of their employment, or as disclosed below.

(a) Remuneration of key management personnel:

	2017	2016
Salaries, accrued bonuses, and employee benefits	$ 1,233,741	$ 1,110,792
Share-based payments	699,138	487,925
	$ 1,932,879	$ 1,598,717

(b) As of September 30, 2017, amounts owing to a company controlled by an officer and director of the Company included in accounts payable and accrued liabilities were $262,854 (2016 - $285,509).

(c) Legal and professional fees, taxes and disbursements totaling $160,664 for the year ended September 30, 2017 (2016 - $137,059) were incurred with a law firm of which a director of the Company is a partner. As of September 30, 2017, amounts owing to this company included in accounts payable and accrued liabilities were $93,219 (2016 - $52,826).

(d) During the year ended September 30, 2016, certain directors and officers of the Company participated in the convertible debenture financing amounting to $350,000.

The above transactions are in the normal course of business and are measured at the exchange amount which is the amount of consideration established and agreed to by the related parties.

LIQUIDITY AND CAPITAL RESOURCES

The Company's principal sources of liquidity are cash provided by operations, including collection of accounts receivable, and access to equity capital resources. The Company's primary short-term cash requirement is to fund operations, working capital, including customer receivables, inventory, supplier payables, capital expenditures, and fixed overhead costs. Cash is also used to finance other long-term strategic business initiatives.

Summary of Statements of Cash Flows

	2017	2016
Cash used in continuing operations	$ (172,904)	$ (3,657,646)
Cash used in discontinued operations	(574,313)	(245,182)
Cash used in operating activities	(747,217)	(3,902,828)
Cash used in investing activities	(106,944)	(148,752)
Cash provided by financing activities	8,339,784	4,317,689
Effect of foreign exchange on cash and cash equivalents	85,605	24,654
Cash and cash equivalents, beginning of year	3,312,691	3,021,928
Cash and cash equivalents, end of year	$ 10,883,919	$ 3,312,691

Operating Activities

Cash used in operating activities was $747,217 for the year ended September 30, 2017, compared to $3,902,828 for the same period last year. This improvement was a result of increased development revenue, strong margins and a working capital decrease during the year.

Investing Activities

Cash used in investing activities was $106,944 for the year ended September 30, 2017, compared to $148,752 used in the same period last year. This reflects reduced expenditures on production equipment in the current period as our production equipment upgrades were concluded early in the previous year.

Financing Activities

Cash provided by financing activities was $8,339,784 for the year ended September 30, 2017, compared to $4,317,689 during the same period last year. This reflects the proceeds of a private placement, the repayment of convertible debentures, the repayment of the note payable and the exercise of stock options during the year.

Capital Resources

The Company's objectives when managing capital are to safeguard the ability to continue as a going concern, to provide adequate return to shareholders, to meet external capital requirements, and preserve financial flexibility in order to benefit from potential opportunities that may arise. Our principal cash requirements are for operations, working capital, and capital expenditures.

The Company's officers are responsible for managing the Company's capital and do so through quarterly meetings and regular review of financial information. The Board of Directors is responsible for overseeing this process. In managing its capital, the Company considers changes in economic conditions, risks that impact consolidated operations, and future significant capital investment opportunities. For the year ended September 30, 2017 there were no changes in our approach to capital management.

As at September 30, 2017, cash and cash equivalents amounted to $10,883,919, compared to $3,312,691 as at September 30, 2016. On May 18, 2017, the Company completed a bought deal private placement with a syndicate of underwriters whereby a total of 11,586,870 common shares of the Company were issued at a price of $1.15 per share, for total gross proceeds of $13,324,901.

During the year, the Company had convertible debentures outstanding with a face value amounting to $4,185,000 with a maturity date of May 31, 2018. The convertible debentures accrued interest at a rate of 12% per annum payable quarterly in arrears and were convertible into common shares of the Company at a price of $1.25 per share. On May 18, 2017, the Company provided notice to the debenture holders of the Company's intention to repay the convertible debentures on June 21, 2017. Most debenture holders elected to convert their debentures into common shares at $1.25 per share. As a result, the Company issued 2,252,000 common shares valued at $2,815,000. The remaining $1,370,000 was repaid.

The Company also had a note payable that was fully secured against the assets of the Company and required interest payments at a fixed rate of 4% per annum, with payment of the principal due on September 16, 2017. On August 21, 2017, the note payable was repaid in full and all security released.

The Company had no lines of credit and no exposure to asset backed commercial paper.

The Company had commitments of $2,605,795 as of September 30, 2017. Management has reviewed its projected funding requirements and expects that through the generation and collection of revenues that the Company will maintain sufficient liquidity to meet its requirements through September 30, 2018.

Non-IFRS Financial Measures

In addition to results reported in accordance with IFRS, the Company discloses Adjusted EBITDA as a supplemental indicator of its financial performance.

The Company defines Adjusted EBITDA as net loss excluding the impact of interest and financing costs (net of interest income), income taxes, depreciation and amortization, share-based compensation, the loss from discontinued operations, and foreign exchange (gain) loss. The Company believes Adjusted EBITDA is a useful measure because it provides information to management about the operating and financial performance of the Company and its ability to generate operating cash flow to fund future working capital needs, and fund future growth. Adjusted EBITDA may also be used by investors and analysts for the purpose of valuing the Company.

Readers are cautioned that these non-IFRS definitions are not recognized measures under IFRS, do not have standardized meanings prescribed by IFRS, and should not be construed to be alternatives to net earnings determined in accordance with IFRS or as indicators of performance or liquidity or cash flows. The Company's method of calculating these measures may differ from methods used by other entities and accordingly our measures may not be comparable to similarly titled measures used by other entities or in other jurisdictions. The Company uses these measures because it believes they provide useful information to both management and investors with respect to the operating and financial performance of the Company.

	Years ended September 30, 2017	Years ended September 30, 2016
Net loss	$ (4,754,132)	$ (7,829,805)
Finance expense	1,014,779	354,720
Foreign exchange loss	169,815	78,793
Deferred income tax recovery	-	(162,797)
Depreciation and amortization	2,916,283	3,077,997
Share-based compensation	921,198	661,786
Loss from discontinued operations	900,279	170,895
Adjusted EBITDA	$ 1,168,222	$ (3,648,411)

Financial Instruments

The Company considers the management of financial risk to be an important part of its overall corporate risk management policy. The nature and extent of risks arising from financial instruments and their related risk management are described in note 12 of the Consolidated Financial Statements for the year ended September 30, 2017. In the year ended September 30, 2017, there was no material change to the nature of the risks arising from our classification of financial instruments, or related risk management objectives.

CAPITAL STRUCTURE AND OUTSTANDING SHARE DATA

The Company maintains an equity incentive plan consisting of a stock option plan and a restricted share unit ("RSU") plan to grant options and RSUs to eligible participants. The maximum number of shares that may be reserved for issuance under the option plan at any point in time is 7% of the Company's issued and outstanding shares. As of February 21, 2017, there were 940,030 RSUs granted but not converted and 216,369 outstanding available for grant. On March 30, 2017, shareholders approved an additional 600,000 RSUs available for grant. As at September 30, 2017, 806,169 RSUs remain available to be granted. The obligations under the RSU plan can be settled at the Company's discretion through either cash or issuance of common shares. The Company intends to settle the obligation through the issuance of common shares.

During the year ended September 30, 2017, 413,500 options (2016 – 796,500) and 499,200 RSUs (2016 – 387,900) were granted. During the year ended September 30, 2017, 590,000 (2016 – 50,000) were forfeited or expired during the year.

The common shares, options, and RSUs outstanding and exercisable as at the following dates are:

	September 30, 2017		September 30, 2016	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Common shares outstanding	68,395,825		53,864,285	
Options				
Outstanding	2,040,000	$ 1.35	2,488,500	$ 1.29
Exercisable	1,770,125	$ 1.37	1,954,625	$ 1.35
RSUs				
Outstanding	529,560	N/A	451,030	N/A

As at December 19, 2017, the Company has 68,395,825 common shares issued and outstanding. There are no preferred shares issued and outstanding.

SIGNIFICANT ACCOUNTING POLICIES AND THE USE OF ESTIMATES

The preparation of financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, revenues, and expenses. Estimates and assumptions are continually evaluated and are based on historical experience and various factors that management believes to be reasonable under the circumstances. However, due to the nature of estimates, actual results may differ from estimates.

The Company's significant accounting policies are contained in note 3 to the consolidated financial statements. Significant areas requiring the use of judgment in application of accounting policies and assumptions and estimates are discussed below.

Going Concern

Financial statements are prepared on a going concern basis unless management either intends to liquidate the Company or to cease trading, or has no realistic alternative to do so. Assessment of the Company's ability to continue as a going concern requires the consideration of all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period. This information includes estimates of future cash flows and other factors, the outcome of which is uncertain. When management is aware, in making its assessment of material uncertainties related to events or conditions that may cast significant doubt upon the Company's ability to continue as a going concern, those uncertainties are disclosed.

Fair Valuation of Financial Instruments

IFRS requires financial instruments to be measured at fair value as at the balance sheet date. In determining fair value, the Company must estimate the price that market participants would sell for, or buy at, in an active liquid market, if there was one. Current market conditions, in which some financial instruments may lack an active market, make it more difficult for the Company to estimate fair value. While management believes the estimates of fair values at the balance sheet date are reasonable, differences in estimates could have an impact on the financial position and results of operations of the Company.

Impairment of Non-financial Assets

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the assets acquired, less liabilities assumed, based on their fair values. Goodwill is not amortized and is tested for impairment at least annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Goodwill is considered to be impaired when the carrying amount of the cash generating unit or group of cash generating units to which the goodwill has been allocated exceeds its fair value. An impairment loss, if any, would be recognized as a separate line item in the statement of earnings.

Intangible assets, acquired individually or with a group of other assets, are initially recognized and measured at cost. The cost of a group of intangible assets acquired in a transaction, including those acquired in a business combination that meet the specified criteria for recognition apart from goodwill, is allocated to the individual assets acquired based on their relative fair values. Intangible assets with finite useful lives are amortized over their estimated useful lives, and are tested for impairment when events or changes in circumstances indicate that an asset might be impaired. The amortization methods and estimated useful lives of intangible assets are reviewed annually. Intangible assets with indefinite useful lives are not amortized and are tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test compares the carrying amount of the intangible asset with its fair value, and an impairment loss would be recognized in income for the excess of carrying value over fair value, if any.

The Company performs impairment tests for goodwill, intangible assets with indefinite lives, and other assets periodically as described above. Impairment tests involve considerable use of judgment and require management to make estimates and assumptions. The fair values of cash generating units are derived from certain valuation models, which consider various factors such as discount rates, future earnings, and perpetual growth rates. Changes in estimates and assumptions can affect the reported value of goodwill and intangible assets with indefinite useful lives.

Provisions

The Company records a provision when an obligation to a third party exists, the payment is probable, and the amount can be reasonably estimated. The Company records a provision based upon the best estimate of the expenditure required to settle the present obligation at the balance sheet date. While management believes these estimates are reasonable, differences in actual results or changes in estimates could have an impact on the liabilities and results of operations recorded by the Company.

Share-based Compensation

The Company measures the fair value of its share-based compensation awards using the Black-Scholes option pricing model and recognizes the fair value expense on a straight-line basis over the relevant vesting period. Management uses judgment to determine the inputs to the Black-Scholes option pricing model including expected plan lives, underlying share price volatility and forfeiture rates. Changes in these assumptions could have a material impact on the calculation of fair value and the amount of compensation expense recorded in earnings.

Investment Tax Credits

The Company recognizes investment tax credits when there is reasonable assurance that they will be realized. Investment tax credits may be carried forward to reduce future Canadian federal and provincial income taxes payable. The Company applies judgment when determining whether the reasonable assurance threshold has been met to recognize investment tax credits in the Consolidated Financial Statements. The Company must interpret eligibility requirements in accordance with Canadian income tax laws and must assess whether future taxable income will be available against which the investment tax credits can be utilized. Any changes in these interpretations and assessments could have a material impact on the amount and timing of investment tax credits recognized in the Consolidated Financial Statements.

Income Taxes

The Company is subject to taxation in numerous jurisdictions and exercises judgment in estimating the provision for federal, provincial, and foreign income taxes. Income tax laws and regulations can be complex and are potentially subject to different interpretation between the Company and the respective tax authority. Provisions for tax are made using the Company's best estimate of the amount of tax expected to be paid or recovered based on an assessment of all relevant factors. However, the precision and reliability of the estimates are subject to uncertainty and may change as additional information becomes known.

Deferred tax assets are recognized only when it is probable that sufficient taxable profit will be available in future periods against which deductible temporary differences may be utilized. The recognition of deferred income tax assets involves considerable use of judgment and requires management to make estimates and assumptions, including estimates of projected taxable income, the timing of the reversal of temporary differences, the tax rates and laws in each respective jurisdiction, and the impact of tax planning strategies. The amount of recognized deferred tax assets may change from period to period due to the uncertainties surrounding these assumptions.

Inventory

Inventory is measured at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses taking into account the most reliable evidence available at each reporting date. The future realization of the inventory may be affected by future technology or other market-driven changes that may reduce future selling prices. While management believes that the estimates of net realizable value as at the balance sheet date are reasonable, differences in estimates could have an impact on the inventory valuation and results of operations of the Company.

Property, Plant, and Equipment

Property, plant, and equipment is measured at cost less accumulated depreciation and accumulated impairment losses. Depreciation expense is recognized based on management's best estimate of the useful lives of the depreciable assets. The Company reviews the estimated useful life annually and recognizes any adjustment as appropriate. While management believes that the estimates of useful lives of depreciable assets as at the balance sheet date are reasonable, differences in estimates could impact the valuation of depreciable assets and the results of operations of the Company.

NEW ACCOUNTING STANDARDS

In July 2014, the IASB issued IFRS 9 - *Financial Instruments*, which replaces the earlier versions of IFRS 9 (2009, 2010, and 2013) and completes the IASB's project to replace IAS 39 - *Financial Instruments: Recognition and Measurement*. IFRS 9 includes a logical model for classification and measurement of financial assets; a single, forward-looking 'expected credit loss' impairment model and a substantially-reformed approach to hedge accounting to better link the economics of risk management with its accounting treatment. IFRS 9 is effective for annual periods beginning on or after January 1, 2018 and must be applied retrospectively, with some exceptions. Earlier adoption is permitted. The Company is currently evaluating the impact of IFRS 9 on its financial statements, and plans to adopt the new standard on the required effective date.

In May 2014, the IASB issued IFRS 15 - *Revenue from Contracts with Customers*, which supersedes IAS 18 - *Revenue,* IAS 11 - *Construction Contracts* and other interpretive guidance associated with revenue recognition. IFRS 15 provides a single, principles-based five-step model to be applied to all contracts with customers to determine how and when an entity should recognize revenue. The standard also provides guidance on whether revenue should be recognized at a point in time or over time as well as requirements for more informative, relevant disclosures. IFRS 15 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. The Company has completed an assessment of the impact that the initial application of IFRS 15 will have on its financial statements and does not expect that there will be a significant impact, other than additional required disclosures. The Company intends to adopt IFRS 15 in its financial statements for the annual period beginning on October 1, 2018.

In January 2016, the IASB issued IFRS 16 - *Leases*, which supersedes IAS 17 - *Leases*. IFRS 16 establishes principles for the recognition, measurement, presentation and disclosure of leases. The standard establishes a single model for lessees to bring leases on balance sheet while lessor accounting remains largely unchanged and retains the finance and operating lease distinctions. IFRS 16 is effective for annual periods beginning on or after January 1, 2019 with earlier adoption permitted, but only if also applying IFRS 15 - *Revenue from Contracts with Customers*. The Company is currently evaluating the impact of IFRS 16 on its financial statements, and plans to adopt the new standard on the required effective date.

BUSINESS RISKS AND UNCERTAINTIES

The Company is subject to a number of risks and uncertainties that can significantly affect its business, financial condition and future financial performance. The Company has a comprehensive process to identify, manage, and mitigate risk, wherever possible. The risks and uncertainties described below are not necessarily the only risks the Company faces. Additional risks and uncertainties that are presently unknown to the Company or deemed immaterial by the Company may adversely affect the Company's business.

History of Operating Losses and Negative Cash Flow

We continue to be an expenditure-based entity, and have incurred substantial losses since our inception and continue to incur losses and experience negative cash flows. We cannot predict if or when we will operate profitably or generate positive cash flows or if we will be able to implement our business strategy successfully. Pursuing our business strategy requires us to incur significant expenditures for research and product development, marketing, and general administrative activities. As a result, we need to continue to grow our revenues and gross margins to achieve and sustain profitability and positive operating cash flows, and we may need to raise additional capital.

Financing Arrangements

Execution of our business plan and our commercial viability could be jeopardized if we are unable to raise additional funds for our working capital, R&D projects, sales, marketing and product development activities, and other business opportunities. We attempt to mitigate this risk by generating funds from a variety of sources including through debt financing, the sale of common equity, government funding, collaboration partners, vendor financing and revenues from our commercial products.

If the cash generated from the Company's business continues to be insufficient to fund future capital requirements, the Company will require additional financing. The Company's ability to access capital markets on terms that are acceptable will be dependent on prevailing market conditions, as well as the Company's future financial condition. Although the Company does not have any reason to anticipate unusual difficulties in raising funds in the future, there can be no assurance that capital will be available on suitable terms and conditions or at all.

Government Contracts and Funding

Changes in government policies, priorities or regulations, funding levels through agency or program budget reductions, the imposition of budgetary constraints or the lack of government appropriations, the delay and/or deferment in governmental contract approvals or government programs could have a material adverse effect on the Company's financial condition, results of operations, or future growth. A decline in governmental support and funding for programs in which the Company or its customers participate could result in contract terminations, delays in contract rewards, the failure to exercise contract options, the cancellation of planned procurements and fewer new business opportunities, any of which could have a material adverse effect on the Company's financial condition and results of operation.

Quality Issues and Contract Performance

The Company sells complex products that could contain defects in design, manufacture and implementation. The products the Company develops and manufactures are technologically advanced and complex. Defects may also occur in components and products that the Company purchases from third parties. The Company employs sophisticated design and testing processes. However, there can be no assurance that the Company's products will be successfully implemented or will pass required acceptance criteria. There can be no assurance that the Company will be able to detect and fix all defects in the products it sells. Failure to do so could result in lost revenue, harm to reputation, significant warranty and other expenses, and could have a material adverse impact on the Company's financial condition and operating results. In addition, a failure with respect to any product may adversely affect the perception by the Company's customers of the quality of its products and may materially and adversely affect the Company's ability to win new contracts.

Acquisitions

The Company has in the past and may continue to expand its operations and business by acquiring additional businesses, products, or technologies. There can be no assurance that the Company will be able to identify, acquire, obtain the required regulatory approvals, or profitably manage additional businesses or successfully integrate any acquired businesses, products or technologies into the Company without substantial expenses, delays or other operational, regulatory, or financial problems. Furthermore, acquisitions may involve a number of additional risks, including diversion of management's attention, failure to retain key personnel, unanticipated events or circumstances, unidentified pre-closing liabilities and other legal liabilities, some or all of which could have an adverse effect on the Company's business, results of operations and financial condition. In addition, there can be no assurance that any acquired businesses, products, or technologies will achieve anticipated revenues and income growth. Acquisitions could also result in potentially dilutive issuances of equity securities. The failure of the Company to manage its acquisitions strategy successfully could have a material adverse effect on the Company's business, results of operations and financial condition.

Fixed Costs

The Company requires a staff of specialized workers, as well as specialized manufacturing and test facilities, to perform under its contracts. In order to maintain its ability to compete, the Company must continuously retain the services of a core group of specialists. This reduces the Company's flexibility to reduce workforce costs in the event of a slowdown or downturn in its business. In addition, the manufacturing and test facilities that the Company owns or leases under long-term agreements are fixed costs that cannot be adjusted quickly to account for significant variance in production requirements or economic conditions.

Dependence on Key Personnel

The success of the Company is largely dependent on the abilities and experience of its executive officers and other key personnel. Competition for highly skilled management, technical, research and development, and other personnel is intense in the Company's industry. There can be no assurance that the Company can retain its current executive officers or key personnel, or attract and retain additional executive officers or key personnel as needed. The loss of certain executive officers or key personnel could have an adverse impact upon the Company's growth, operations and profitability.

Technological Change

The banknote, branding and security markets in which the Company operates are characterized by changing technology and evolving industry standards. The Company's actual and planned products embody complex technology and may not always be compatible with current and evolving technical standards developed by others. Failure or delays by the Company to meet or comply with the requisite and evolving industry or user standards could have a material adverse effect on the Company's business, results of operations and financial condition. The Company's ability to anticipate changes in technology, technical standards and the needs of the industries it serves or proposes to serve will be a significant factor in the Company's ability to compete or expand into new markets.

Retention of Markets and Development of New Offerings

The Company may experience design, manufacturing, marketing and other difficulties that could delay or prevent the development, introduction or acceptance of new products and enhancements. There can be no assurance that the Company will be able to anticipate and achieve the technological advances necessary to remain competitive and profitable, that new products or enhancements will be developed and manufactured on schedule or on a cost-effective basis, or that the Company's existing products will not become technologically obsolete. The Company's failure to accurately predict the needs of current and prospective customers, and to develop products or enhancements that address those needs, may result in the loss of current customers or the inability to secure new customers.

Significant Competition

Many of the Company's competitors are larger and have substantially greater resources than the Company. Furthermore, it is possible that other domestic or foreign companies or governments, some with greater experience in the industry in which the Company operates and many with greater financial resources than the Company possesses, could seek to produce products that compete with the Company's products, including the use of new technology which could render the Company's products less competitively viable. Some of the Company's foreign competitors currently benefit from, and others may benefit in the future from, subsidies or protective measures by their home countries. Furthermore, government agencies may at any time decide to perform similar work as the Company either for themselves or for other government agencies, effectively competing with the Company.

The Company's financial performance is dependent on its ability to generate a sustainable order rate for its manufacturing operations. This can be challenging and may fluctuate on an annual and quarterly basis as the number of contracts awarded varies and is difficult to predict. There is also competitive pressure on pricing and other material contractual terms, such as those allocating risk between the manufacturer and its customers.

Intellectual Property Rights

To protect the Company's proprietary rights, the Company relies on a combination of patent protections, copyrights, trade secrets, trademark laws, confidentiality agreements with employees and third parties, and protective contractual provisions such as those contained in licence agreements with consultants, subcontractors, vendors and customers. Despite these efforts, the Company's intellectual property rights may be invalidated, circumvented, challenged, infringed or required to be licensed to others, which could have a material adverse effect on the Company's business, financial condition or operating results. An infringement or misappropriation could harm any competitive advantage the Company currently derives or may derive from its proprietary rights. Litigation may be necessary to enforce or protect the Company's intellectual property rights, protect its trade secrets or determine the validity and scope of the proprietary rights of others. Such litigation may be time-consuming and expensive to prosecute or defend and could result in the diversion of the Company's time and resources.

If any of the Company's technology violates proprietary rights, including copyrights and patents, third parties may assert infringement claims against the Company. Any claims from third parties may also result in limitations on the Company's ability to use the intellectual property subject to these claims. The Company may be required to redesign its products or obtain licences from third parties to continue offering the Company's products without substantially re-engineering such products or defending itself and its customers against infringement claims and liability for damages. This may affect the Company's operations and, in addition, the Company could suffer substantial costs in defending itself against infringement claims.

Economic and Political Conditions

Customer demand for the Company's products may be affected by economic and political conditions on an international, national and/or regional level. For example, changes in interest rates, foreign exchange rates, credit availability, the level of government spending, the cyclical nature of the market, and political decisions may adversely influence the Company's sales or the Company's ability to access certain funding.

Security Environment

Many of the Company's customers have specific security requirements relating to the work that can be performed for it. These requirements can change quickly and with little notice causing reduction or even elimination of potential work for the Company and the ability of the Company to participate in future business. Any reduction or elimination of work could have an adverse effect on the revenues and margins of the Company.

Insurance

The Company maintains an extensive program of insurance coverage in the normal course of business, consistent with similar businesses. In addition, the insurance program covers some of the unique risks encountered by the Company. Although the limits and deductibles of such insurance have been established through risk analysis and the recommendation of professional advisors, there can be no assurance that such insurance will remain available to the Company at commercially reasonable rates or that the amount of such coverage will be adequate to cover all liability incurred by the Company. If the Company is held liable for amounts exceeding the limits of its insurance coverage or for claims outside the scope of that coverage, its business, results of operations and financial condition could be adversely affected.

ADDITIONAL INFORMATION

Outlook

Nanotech is a leader in next-generation anti-counterfeiting products. These products have brand protection and enhancement applications across a wide range of markets including banknotes, secure government documents, commercial branding, and the pharmaceutical industry. Nanotech is initially focusing its efforts on the banknote market due to its strong margins and established customer base. With the recent signing of the $30 million development contract, the Company is focusing on further developing business with its established customer base and, as a result, is well positioned to expand its authentication development contract revenue and other nano-optic and OTF opportunities in the years ahead.

In 2017, management established goals to double its revenue and make significant progress towards becoming cash flow positive. Management is pleased that it has exceeded both goals for 2017 with revenue growth of 154% and achieving positive Adjusted EBITDA of $1,168,222 for the year. In addition, the Company has developed many significant market opportunities in the banknote, tax stamp and commercial markets.

Looking ahead to 2018, the Company is well positioned financially to pursue these opportunities. With a strong balance sheet including $10,883,919 in cash and no debt, management has established the following goals for 2018:

1. Grow revenues by 20% to 40% (which excludes the potential Asian OTF order);
2. Begin to collect licensing revenue from the tax stamp and commercial markets;
3. Maintain a strong focus on earnings with a target of 15% to 20% Adjusted EBITDA margin;
4. Continue to pursue a volume OTF partnering opportunity with Hueck Folien for Asian banknotes;
5. Invest in several key marketing hires to ensure internal resources are in place to develop the products, sales channels, and marketing materials necessary to penetrate potential commercial markets; and
6. Continue to open new corporate development opportunities by partnering with established companies to enable Nanotech to enter new markets.

Achieving these results is not certain and involves known and unknown risks that may cause actual results to differ materially from this goal. These risks and uncertainties include, among other things, risks related to uncertainty of amount and timing of purchase orders, the ability of Hueck Folien to successfully deliver volume production, and our ability to expand our development revenue. These and other risk factors are further discussed under the "Business Risks and Uncertainties" segment of this MD&A.

Public Securities Filings

Additional information about Nanotech, is available on the Company's website at www.nanosecurity.ca, or on SEDAR at www.sedar.com.

Consolidated Financial Statements of

Nanotech Security Corp.

Years ended September 30, 2017 and 2016

Nanotech Security Corp.
September 30, 2017 and 2016

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KPMG LLP
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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Nanotech Security Corp.

We have audited the accompanying consolidated financial statements of Nanotech Security Corp., which comprise the consolidated statements of financial position as at September 30, 2017 and September 30, 2016, the consolidated statements of operations and comprehensive loss, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Nanotech Security Corp. as at September 30, 2017 and September 30, 2016, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards.

KPMG LLP

Chartered Professional Accountants

December 21, 2017
Vancouver, Canada

Nanotech Security Corp.

Consolidated Statements of Operations and Comprehensive Loss
Years ended September 30, 2017 and 2016

(In Canadian dollars)

	2017	2016
Revenue	$ 7,343,791	$ 2,888,896
Cost of sales (note 16)	1,429,371	884,132
Gross profit	5,914,420	2,004,764
Expenses (note 16)		
Research and development	1,475,437	1,996,715
General and administration	2,308,846	2,307,368
Sales and marketing	2,043,514	2,078,612
Depreciation and amortization	2,755,882	3,010,263
	8,583,679	9,392,958
Loss from continuing operations before other expenses	(2,669,259)	(7,388,194)
Other expenses		
Foreign exchange loss	169,815	78,793
Finance expense (note 9)	1,014,779	354,720
	1,184,594	433,513
Loss from continuing operations before income taxes	(3,853,853)	(7,821,707)
Deferred income tax recovery (note 13)	-	162,797
Net loss from continuing operations	(3,853,853)	(7,658,910)
Loss from discontinued operations (note 18)	(900,279)	(170,895)
Net loss	(4,754,132)	(7,829,805)
Other comprehensive income:		
Items that may be subsequently reclassified to earnings:		
Unrealized foreign exchange gain on translation of foreign operation	85,605	24,654
Total comprehensive loss	$ (4,668,527)	$ (7,805,151)
Basic and diluted loss per share:		
Continuing operations	$ (0.07)	$ (0.14)
Discontinued operations	$ (0.01)	$ (0.01)
Net loss	$ (0.08)	$ (0.15)
Weighted average number of common shares		
Basic and diluted	59,056,353	53,524,646

See accompanying notes to Consolidated Financial Statements.

Nanotech Security Corp.

Consolidated Statements of Financial Position
as at September 30, 2017 and 2016

(In Canadian dollars)

	2017	2016
Assets		
Current assets:		
Cash and cash equivalents	$ 10,883,919	$ 3,312,691
Accounts receivable (note 12(b))	1,374,442	597,414
Inventory (note 5)	151,708	385,753
Prepaid expenses and other assets	187,874	127,719
Assets held for sale (note 18)	216,225	-
	12,814,168	4,423,577
Property, plant and equipment (note 6)	15,856,998	17,338,312
Goodwill (note 7(a))	1,388,458	1,388,458
Intangible assets (note 7(b))	-	1,361,239
	$ 30,059,624	$ 24,511,586
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 1,431,466	$ 1,395,568
Deferred revenue	157,171	-
Liabilities directly associated with assets held for sale (note 18)	200,226	-
Note payable (note 8)	-	3,000,000
	1,788,863	4,395,568
Non-current liabilities:		
Convertible debentures (note 9)	-	3,595,142
Tenant inducement	71,223	98,793
	1,860,086	8,089,503
Shareholders’ equity		
Share capital (note 10(a))	61,426,483	45,210,507
Contributed surplus (note 9)	2,715,137	2,485,131
Deficit	(35,873,177)	(31,119,045)
Accumulated other comprehensive loss	(68,905)	(154,510)
	28,199,538	16,422,083
	$ 30,059,624	$ 24,511,586

Related party transactions (note 14).
Commitments (note 17).
See accompanying notes to Consolidated Financial Statements.

Approved on behalf of the Board of Directors:

"Doug Blakeway" *"Ken Tolmie"*

Doug Blakeway, Director Ken Tolmie, Director

Nanotech Security Corp.

Consolidated Statements of Changes in Equity
Years ended September 30, 2017 and 2016

(In Canadian dollars)

	Number of shares	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at October 1, 2015	53,387,215	$ 44,666,497	$ 1,726,780	$ (23,289,240)	$ (179,164)	$ 22,924,873
Net loss	-	-	-	(7,829,805)	-	(7,829,805)
Unrealized foreign exchange gain on translation	-	-	-	-	24,654	24,654
Fair value of equity component of convertible debentures on issuance, net of transaction costs (note 9)	-	-	605,972	-	-	605,972
Deferred tax liability relating to convertible debentures (note 9)	-	-	(162,797)	-	-	(162,797)
Share-based payments (note 10(c) and (d))	-	-	661,786	-	-	661,786
RSUs vested (note 10(d))	237,070	258,406	(258,406)	-	-	-
Options exercised (note 10(c))	240,000	285,604	(88,204)	-	-	197,400
Balance as at September 30, 2016	53,864,285	$ 45,210,507	$ 2,485,131	$ (31,119,045)	$ (154,510)	$ 16,422,083
Net loss	-	-	-	(4,754,132)	-	(4,754,132)
Unrealized foreign exchange gain on translation	-	-	-	-	85,605	85,605
Shares issued, net of issuance costs (note 10(a))	11,586,870	12,486,784	-	-	-	12,486,784
Shares issued on conversion of convertible debentures (note 9)	2,252,000	2,815,000	-	-	-	2,815,000
Share-based payments (note 10(c) and (d))	-	-	921,198	-	-	921,198
RSUs vested (note 10(d))	420,670	567,905	(567,905)	-	-	-
Options exercised (note 10(c))	272,000	346,287	(123,287)	-	-	223,000
Balance as at September 30, 2017	68,395,825	$ 61,426,483	$ 2,715,137	$ (35,873,177)	$ (68,905)	$ 28,199,538

See accompanying notes to Consolidated Financial Statements.

Nanotech Security Corp.

Consolidated Statements of Cash Flows
Years ended September 30, 2017 and 2016

(In Canadian dollars)

	2017	2016
Cash flows provided by (used in):		
Operating activities:		
Net loss from continuing operations	$ (3,853,853)	$(7,658,910)
Items not involving cash:		
Depreciation and amortization	2,917,883	3,077,997
Share-based compensation	921,198	661,786
Accretion of convertible debentures	589,858	80,825
Other	(27,570)	(27,570)
Deferred income taxes	-	(162,797)
Non-cash working capital changes (note 15(a))	(720,420)	371,023
	(172,904)	(3,657,646)
Discontinued operations (note 18):		
Net loss from discontinued operations	(900,279)	(170,895)
Depreciation	12,804	17,689
Items not involving cash	313,162	(91,976)
Cash used in operating activities	(747,217)	(3,902,828)
Investing activities:		
Purchase of property and equipment	(106,944)	(148,752)
Cash used in investing activities	(106,944)	(148,752)
Financing activities:		
Issuance of shares for options exercised	223,000	197,400
Proceeds on financing, net of costs (note 10(a))	12,486,784	-
Repayment of note payable (note 8)	(3,000,000)	-
Repayment of convertible debentures (note 9)	(1,370,000)	-
Proceeds on issuance of convertible debentures, net of costs	-	4,120,289
Cash provided by financing activities	8,339,784	4,317,689
Effect of foreign exchange on cash and cash equivalents	85,605	24,654
Increase in cash and cash equivalents	7,571,228	290,763
Cash and cash equivalents, beginning of year	3,312,691	3,021,928
Cash and cash equivalents, end of year	$ 10,883,919	$ 3,312,691

See supplementary cash flow information (note 15).
See accompanying notes to Consolidated Financial Statements.

1. Summary of business:

Nanotech Security Corp. (the “Company” or “Nanotech”) is incorporated under the laws of British Columbia with common shares listed on the TSX Venture Exchange (trading symbol: NTS) and quoted in the United States on the OTCQX Market (trading symbol: NTSFF). The Company’s head office is located at #505 - 3292 Production Way, Burnaby, British Columbia, Canada V5A 4R4.

Nanotech designs, produces and markets nano-optic products that have brand protection and enhancement applications across a wide range of markets including banknotes, tax stamps, and commercial branding.

2. Basis of preparation:

(a) *Statement of compliance:*

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”). The financial statements were approved by the Company’s Board of Directors and authorized for issue on December 19, 2017.

Certain comparative figures in the consolidated statements of operations and comprehensive loss have been reclassified to conform to the current period’s presentation. This reclassification had no impact on the net loss from continuing operations, the net loss, or total comprehensive loss.

(b) *Basis of measurement:*

These consolidated financial statements are presented in Canadian dollars and have been prepared on a historical cost basis, except for certain financial instruments which are measured at fair value.

(c) *Use of estimates, assumptions and judgments*:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. The estimates and underlying assumptions are reviewed by management on an ongoing basis. Revisions to accounting estimates are accounted for prospectively. The key sources of estimation uncertainty that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities are discussed below:

(i) Valuation of goodwill:

Goodwill arising on an acquisition of a business is carried at cost, as established at the date of acquisition of the business less impairment losses, if any. For purposes of impairment testing, goodwill is allocated to each of the Company’s cash-generating units (“CGU”) that is expected to benefit from the synergies of the combination. A CGU to which goodwill has been allocated is tested for impairment annually, or more frequently when there is an indication that the CGU may be impaired.

2. Basis of preparation (continued):

(c) *Use of estimates, assumptions and judgments (continued):*

(i) Valuation of goodwill (continued):

Management evaluates goodwill for impairment annually as of September 30th. While management uses their best estimate and assumptions to assess goodwill impairment, there are inherent uncertainties in projecting future cash flows.

(ii) Judgments:

Management uses judgment when applying accounting policies and when making estimates and assumptions as described above. The most significant areas that require judgment include determination of functional currency, the estimated useful life of property, plant and equipment, goodwill, and determination of CGUs and segments.

(d) *Basis of consolidation:*

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Tactical Technologies Inc. ("TTI"). All intercompany balances and transactions are eliminated on consolidation. The financial statements of the subsidiaries are included in the consolidated financial statements from the date that control commences.

(e) *Foreign currency translation:*

The consolidated financial statements of the Company are presented in Canadian dollars. The functional currency of the Company is the Canadian dollar. TTI's functional currency is the U.S. dollar.

(i) Transactions in foreign currency:

Each entity within the consolidated group records transactions using its functional currency, being the currency of the primary economic environment in which it operates. Foreign currency transactions are translated into the respective functional currency of each entity using the foreign currency rates prevailing at the date of the transaction. Period end balances of monetary assets and liabilities in foreign currency are translated to the respective functional currencies using period end foreign currency rates. Foreign currency gains and losses arising from settlement of foreign currency transactions are recognized in earnings.

(ii) Foreign operations translation:

The assets and liabilities of foreign operations are translated into Canadian dollars at period end foreign currency rates. Revenues and expenses of foreign operations are translated into Canadian dollars at average rates for the period. Foreign currency translation gains and losses are recognized in other comprehensive loss. The relevant amount in accumulated other comprehensive loss is reclassified into earnings upon disposition of a foreign operation.

3. Significant accounting policies:

(a) *Revenue recognition:*

Revenue is measured at the fair value of consideration received or receivable, net of discounts and after eliminating intercompany sales.

The Company's contracts with customers may include multiple deliverables that fall within one or more of the revenue categories described below. Where revenue arrangements have separate identifiable components, the consideration received is allocated to each identifiable component and the applicable revenue recognition criteria are applied to each of the components.

Revenue from the sale of products is recognized when all of the following conditions have been met:

- title and risk involving the products are transferred to the buyer;
- the Company's managerial involvement over the goods ceases to exist;
- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the Company; and
- the costs incurred in respect of the transaction can be measured reliably.

If there is a requirement for customer acceptance of any products shipped, revenue is recognized only after customer acceptance has been received. Payments received in advance of the satisfaction of the Company's revenue recognition criteria are recorded as deferred revenue.

Revenue from development contracts are recognized by reference to the stage of completion based on services performed to date as a percentage of total services to be performed or on a straight-line basis over the term of the contract, if revenue is determined to be earned evenly.

(b) *Earnings per common share:*

Basic net loss per common share is calculated using the weighted average number of common shares outstanding during the year.

Diluted net loss per share reflects the potential dilution of common share equivalents, such as outstanding stock options and warrants, in the weighted average number of common shares outstanding during the year, if dilutive. For this purpose, the "treasury stock method" is used for the assumed proceeds upon the exercise of outstanding stock options that are used to purchase common shares at the average market price during the period. For the periods presented, basic and diluted figures are the same, as the exercise of all warrants, stock options and restricted share units ("RSU") would be anti-dilutive.

(c) *Research and development:*

Research costs are expensed in the period incurred. Development costs are capitalized and recorded as an intangible asset only if technical feasibility has been established and the Company expects to generate probable future economic benefits from the asset created on completion of development. The costs capitalized include materials, direct labour, directly attributable overhead

3. Significant accounting policies (continued):

(c) *Research and development (continued):*

expenditures, and borrowing costs on qualifying assets. Other development costs are expensed in the period incurred. During the years ended September 30, 2017 and 2016, all development costs have been expensed.

(d) *Government assistance and investment tax credits:*

Government assistance includes government grants and investment tax credits and is recognized when there is reasonable assurance that the Company will comply with the relevant conditions and that the government assistance will be received. Government assistance that meets the recognition criteria and relates to current expenses is recorded as a reduction of research and development expense.

Government assistance that meets the recognition criteria and relates to the acquisition of an asset is recorded as a reduction of the cost of the related asset. If government assistance becomes repayable, the inception to date impact of assistance previously recognized in earnings is reversed immediately in the period that the assistance becomes repayable.

Investment tax credits are recorded using the cost-reduction method whereby the credits are deducted from the cost of the related asset or expenditure when there is reasonable assurance that the investment tax credit will be realized. Where a valuation allowance has been recorded against prior year's investment tax credits, the Company applies the credits on a first-in first-out basis with a recovery of prior year's investment tax credits recognized as an income tax recovery.

(e) *Financial instruments:*

Financial assets and financial liabilities are initially measured at fair value and are subsequently re-measured based on their classification as described below. Transaction costs that are directly attributable to the acquisition or issuance of a financial asset or liability, other than financial assets and liabilities recorded at fair value through earnings, are added or deducted from the fair value of the respective financial asset or financial liability on initial recognition. Transaction costs that are directly attributable to the acquisition of a financial asset or financial liability recorded at fair value through earnings are recognized immediately in earnings.

Financial assets and liabilities are offset and the net amount is reported in the Statement of Financial Position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis or realize the asset and settle the liability simultaneously.

(i) Financial assets:

Financial assets are classified into the following categories: financial assets at fair value through earnings, loans and receivables, and available-for-sale. The classification depends on the nature and purpose of the financial asset and is determined at the time of initial recognition.

3. Significant accounting policies (continued):

(e) *Financial instruments (continued):*

(i) Financial assets (continued):

- Financial assets at fair value through earnings:
  Financial assets are classified as at fair value through earnings when held for trading or if designated into this category. Financial assets classified as financial assets at fair value through earnings are measured at fair value with any gains or losses arising on remeasurement recognized in earnings. The Company does not have any financial assets classified as fair value through earnings.

- Loans and receivables:
  Loans and receivables include cash and cash equivalents, and other receivables. Loans and receivables are initially measured at fair value and are subsequently remeasured at amortized cost using the effective interest method, less any impairment losses. The Company has classified cash and cash equivalents and accounts receivables as loans and receivables.

- Available-for-sale financial assets:
  Available-for-sale financial assets are non-derivative financial assets that are either designated in this category or not classified into any of the other categories. Available-for-sale financial assets are measured at fair value with any gains or losses on remeasurement recognized in other comprehensive income until the financial asset is derecognized or is determined to be permanently impaired, at which time the gain or loss accumulated in equity is transferred to earnings. The Company does not have any financial assets classified as available-for-sale assets.

Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred, and the Company has transferred substantially all of the risks and rewards of ownership.

(ii) Financial liabilities:

Financial liabilities are classified as either financial liabilities at fair value through earnings or as other financial liabilities.

- Other financial liabilities:
  Other financial liabilities include trade and other payables, non-trade payables, contingent liabilities, and long-term debt. They are initially measured at fair value and are subsequently measured at amortized cost using the effective interest method. The Company has classified accounts payables and accrued liabilities, and a secured note payable as other financial liabilities.

(iii) Compound instruments:

The liability and equity components of compound instruments (including convertible debentures) issued by the Company are presented separately on the Consolidated Statements of Financial Position.

The liability component is recognized initially at fair value; calculated by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar non-convertible liability of comparable credit status and providing substantially the same cash flows as the instrument. Subsequent to initial recognition, the liability component is measured at amortized cost using the

3. Significant accounting policies (continued):

(e) *Financial instruments (continued):*

(iii) Compound instruments (continued):

effective interest method, and increased by accretion of the discounted amounts to reach the nominal value of the convertible debentures at maturity.

The carrying amount of the conversion option, classified as equity, is calculated by deducting the amount of the liability from the fair value of the instrument as a whole. The equity component is presented in shareholders' equity and is shown net of income tax effects. The equity component is not re-measured subsequent to initial recognition, and will remain in equity until the conversion option is exercised.

Transaction costs are allocated on a pro-rata basis to each separately accounted component.

(iv) Embedded derivatives:

Derivatives embedded in non-derivative host contracts are treated as separate derivatives when they meet the definition of a derivative, their risks and characteristics are not closely related to those of the host contracts and the contracts are not measured at the fair value through earnings. Embedded derivatives are recorded at the fair value through earnings. During the years ended September 30, 2017 and 2016, the Company did not have any embedded derivatives.

(f) *Cash and cash equivalents:*

Cash and cash equivalents is comprised of cash on hand, cash balances with banks and similar institutions, and term deposits redeemable within three months or less from the date of acquisition with banks and similar institutions.

(g) *Inventory:*

Inventory is measured at the lower of cost and net realizable value and consists primarily of raw materials used in the manufacturing of optical thin film. Raw materials cost is determined on a weighted average basis. The cost of work in progress and finished goods includes the cost of raw material, direct labour and an allocation of related overheads. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

3. Significant accounting policies (continued):

(h) *Property, plant and equipment:*

Property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. The initial cost of an asset comprises its purchase price and any costs directly attributable to bringing the asset into working condition for its intended use. Assets acquired in a business combination are measured at the fair value of the assets at the time of acquisition. Repairs and maintenance costs are charged directly to the statement of operations as incurred. Depreciation is calculated using the following methods and annual rates:

	Estimated useful life
Software	100% declining balance
Laboratory and office equipment	20 - 55% declining balance
Manufacturing equipment	10% declining balance
Building	4% declining balance
Leasehold improvements	5 year straight-line

The Company reviews the estimated useful lives and the depreciation methods of its property, plant and equipment annually.

(i) *Intangible assets and goodwill:*

(i) Intangible assets:

Intangible assets with finite lives consist of acquired intellectual property and are measured at cost less accumulated amortization and accumulated impairment losses. Cost for intangible assets acquired in a business combination represents the fair value of the asset at the time of the acquisition. Intangible assets with finite lives are amortized over four years. At September 30, 2017 and 2016, the Company did not have any indefinite life intangible assets other than goodwill.

(ii) Goodwill:

Goodwill arising on an acquisition of a business is carried at cost, as established at the date of acquisition of the business less accumulated impairment losses, if any. Goodwill is not amortized but is tested for impairment annually or whenever there is an indication of impairment.

(j) *Impairment:*

(i) Financial assets:

Financial assets not carried at fair value through earnings are assessed for impairment at each reporting date. A financial asset is impaired if objective evidence indicates that a loss event which negatively affected the estimated future cash flows has occurred after the initial recognition of the asset. For financial assets measured at amortized cost, the impairment loss is the difference between the carrying amount and the present value of the estimated future cash flows, discounted at the original effective interest rate. If an impairment has occurred, the carrying amount of the asset is reduced to its

3. Significant accounting policies (continued):

(j) *Impairment (continued):*

(i) Financial assets (continued):

recoverable amount, with the amount of the loss recognized in earnings. A permanent impairment loss for an available-for-sale investment is recognized by transferring the cumulative loss previously recognized in other comprehensive income to earnings.

(ii) Non-financial assets:

Goodwill and non-financial assets are tested for impairment annually, or whenever events or changes in circumstances indicate that an asset's carrying amount may be less than its recoverable amount. Management uses judgment to estimate the inputs to these assessments and any changes to these inputs could have a material impact on the impairment calculation. For impairment testing, non-financial assets that do not generate independent cash flows are grouped together into a CGU, which represent the level at which largely independent cash flows are generated. Goodwill is allocated to groups of CGUs based on the level at which it is monitored for internal reporting purposes. An impairment loss is recognized in earnings to the extent that the carrying value of an asset, CGU or group of CGUs exceeds its estimated recoverable amount. The recoverable amount of an asset, CGU or group of CGUs is the greater of its value in use and its fair value less cost to sell. Value in use is calculated as the present value of the estimated future cash flows discounted at appropriate discount rates. An impairment loss relating to a specific asset reduces the carrying value of the asset. An impairment loss relating to a CGU or group of CGUs reduces the carrying value of the goodwill allocated to the CGU or group of CGUs, then reduces the carrying value of the other assets of the CGU or group of CGUs on a pro-rata basis. An impairment loss in respect of goodwill is not reversed. A previously recognized impairment loss related to other non-financial assets is assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss related to other non-financial assets is reversed if there is a subsequent increase in recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying value does not exceed the carrying value that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

(k) *Provisions:*

Provisions represent liabilities for which the amount or timing is uncertain. Provisions are recognized when the Company has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Where appropriate, the future cash flow estimates are adjusted to reflect risks specific to the liability.

(l) *Share-based payments:*

The Company makes share-based payments to directors, consultants and employees. The compensation expense for share-based payment is determined based on the fair value at the grant date using the Black-Scholes option-pricing model and is recorded in the statement of operations over the vesting period. Management uses judgment to determine the inputs to the Black-Scholes option-pricing model including the expected plan lives, underlying share price volatility and forfeiture rates. Volatility is estimated by considering the Company’s historic share price volatility over similar periods to the expected life of the awards under consideration. Changes in these assumptions will impact the calculation of fair value and the

3. Significant accounting policies (continued):

(l) *Share-based payments (continued):*

amount of compensation expense recognized in earnings. When stock options are exercised, any consideration paid by directors, consultants and employees, as well as the related stock-based compensation, is credited to share capital.

(m) *Restricted share units:*

During the year ended September 30, 2015, the Company adopted a RSU plan. The obligations under the RSU plan can be settled at the Company's discretion through either cash or the issuance of common shares. The Company measures the cost of equity-settled share-based transactions by reference to the fair value of the equity instruments at the date at which they are granted and is recorded in the statement of operations over the vesting period. For RSUs, the Company uses the TSXV share price at the grant date as fair value of the RSUs. The resulting fair value is then adjusted for an estimated forfeiture amount. Determination of the forfeiture rate is based on historical experience. The actual number of RSUs that vest is likely to be different from estimation.

(n) *Income taxes:*

Income tax expense is comprised of current and deferred tax. Current and deferred tax are recognized into earnings except to the extent that it relates to a business combination or items recognized directly in other comprehensive income or share capital.

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

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

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

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

3. Significant accounting policies (continued):

(o) *Leases:*

Leasing contracts are classified as either finance or operating leases based on the substance of the contractual arrangement at inception date. A lease is classified as a finance lease if it transfers substantially all of the risks and rewards of ownership of the leased asset. Where the contracts are classified as finance leases, upon initial recognition, the asset and liability are recorded at the lower of fair value and the present value of the minimum lease payments, net of executory costs. Finance lease payments are apportioned between interest expense and repayments of the liability. Where the contracts are classified as operating leases, they are not recognized in the Company's Consolidated Statements of Financial Position and lease payments are charged to earnings as they are incurred on a straight-line basis over the lease term.

(p) *Segment reporting:*

The Company's continuing operations currently consists of one operating segment.

(q) *Assets held for sale and discontinued operations:*

(i) Assets held for sale:

The Company classifies assets, or disposal groups, as held for sale when it expects to recover their carrying amounts primarily through sale rather than through continuing use. To meet criteria to be held for sale, the sale must be highly probable, and the assets or disposal groups must be available for immediate sale in their present condition. The Company must be committed to a plan to sell the assets or disposal group, and the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification.

The Company measures assets or disposal groups at the lower of their carrying amount and fair value less costs to sell. Any impairment loss on a disposal group is first allocated to goodwill, and then to remaining assets and liabilities on a pro-rata basis, except that no loss is allocated to inventories or financial assets. Impairment losses on initial classification as held for sale and subsequent gains and losses on remeasurement are recognized in the statement of income; however, gains are not recognized in excess of any cumulative impairment loss. Upon classifying asset or disposal groups as held for sale, the Company presents the assets separately as a single amount and the associated liabilities separately as a single amount on the Consolidated Statement of Financial Position. Comparative period Consolidated Statements of Financial Position are not restated. Assets held for sale are not depreciated, depleted, or amortized.

(ii) Discontinued operations:

A discontinued operation is a component of the Company's business that represents a separate major line of business or geographical area of operations that has been disposed of or classified as held for sale. The operations and cash flows can be clearly distinguished from the rest of the Company, both operationally and for financial reporting purposes. When the Company classifies an operation as a discontinued operation, it re-presents the comparative Consolidated Statements of Operations as if the operation had been discontinued from the start of the comparative year. In doing this, the Company excludes the results for the discontinued operations and any gain or loss from disposal from the consolidated statements of operations from continuing operations and presents them on a separate line as profit or loss (net of tax) from the discontinued operation. Per share information and changes to

3. Significant accounting policies (continued):

(q) *Assets held for sale and discontinued operations (continued):*

(ii) Discontinued operations (continued):

other consolidated comprehensive loss related to discontinued operations are presented separately from continuing operations. Cash flows from discontinued operations are presented separately from cash flows from continuing operations in the Consolidated Statements of Cash Flows.

4. New standards and interpretations not yet adopted:

(a) *IFRS 9 – Financial Instruments:*

In July 2014, the IASB issued IFRS 9 – *Financial Instruments*, which replaces the earlier versions of IFRS 9 (2009, 2010, and 2013) and completes the IASB's project to replace IAS 39 – *Financial Instruments: Recognition and Measurement*. IFRS 9 includes a logical model for classification and measurement of financial assets; a single, forward-looking 'expected credit loss' impairment model and a substantially-reformed approach to hedge accounting to better link the economics of risk management with its accounting treatment. IFRS 9 is effective for annual periods beginning on or after January 1, 2018 and must be applied retrospectively, with some exceptions. Earlier adoption is permitted. The Company is currently evaluating the impact of IFRS 9 on its financial statements, and plans to adopt the new standard on the required effective date.

(b) *IFRS 15 – Revenue from contracts with customers:*

In May 2014, the IASB issued IFRS 15 – *Revenue from Contracts with Customers*, which supersedes IAS 18 – *Revenue,* IAS 11 – *Construction Contracts* and other interpretive guidance associated with revenue recognition. IFRS 15 provides a single, principles-based five-step model to be applied to all contracts with customers to determine how and when an entity should recognize revenue. The standard also provides guidance on whether revenue should be recognized at a point in time or over time as well as requirements for more informative, relevant disclosures. IFRS 15 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. The Company has completed an assessment of the impact that the initial application of IFRS 15 will have on its financial statements, and does not expect that there will be a significant impact, other than additional required disclosures. The Company intends to adopt IFRS 15 in its financial statements for the annual period beginning on October 1, 2018.

(c) *IFRS 16 – Leases:*

In January 2016, the IASB issued IFRS 16 – *Leases*, which supersedes IAS 17 – *Leases*. IFRS 16 establishes principles for the recognition, measurement, presentation and disclosure of leases. The standard establishes a single model for lessees to bring leases on balance sheet while lessor accounting remains largely unchanged and retains the finance and operating lease distinctions. IFRS 16 is effective for annual periods beginning on or after January 1, 2019 with earlier adoption permitted, but only if also applying IFRS 15 – *Revenue from Contracts with Customers*. The Company is currently evaluating the impact of IFRS 16 on its financial statements, and plans to adopt the new standard on the required effective date.

(Expressed in Canadian dollars)

5. Inventory:

	2017	2016
Raw materials	$ 123,619	$ 309,055
Work in progress	28,089	76,698
	$ 151,708	$ 385,753

At September 30, 2017, work in progress includes $1,600 of depreciation (2016 - $nil).

During the year ended September 30, 2017, there were no write-downs of inventories to net realizable value. During the year ended September 30, 2016, the write-down of inventories to net realizable value amounted to $104,524.

For the year ended September 30, 2017, the Company recognized inventories of $1,429,371 (2016 - $884,132) through cost of sales.

(Expressed in Canadian dollars)

6. Property, plant and equipment:

	Land	Building and leasehold improvement	Manufacturing equipment	Laboratory, software, and office equipment	Total
Cost:					
Balance as at October 1, 2015	141,700	3,807,861	15,780,777	554,760	20,285,098
Additions	-	-	142,179	6,573	148,752
Disposals	-	-	-	(35,372)	(35,372)
Foreign currency translation	-	(483)	-	(5,548)	(6,031)
Balance as at September 30, 2016	141,700	3,807,378	15,922,956	520,413	20,392,447
Additions	-	92,009	-	14,935	106,944
Assets held for sale	-	(27,809)	-	(290,293)	(318,102)
Balance as at September 30, 2017	$ 141,700	$ 3,871,578	$ 15,922,956	$ 245,055	$ 20,181,289
Accumulated depreciation:					
Balance as at October 1, 2015	-	185,095	802,580	376,027	1,363,702
Depreciation expense	-	169,516	1,504,929	56,851	1,731,296
Disposals	-	-	-	(35,372)	(35,372)
Foreign currency translation	-	(483)	-	(5,008)	(5,491)
Balance as at September 30, 2016	-	354,128	2,307,509	392,498	3,054,135
Depreciation expense	-	167,144	1,361,544	27,956	1,556,644
Assets held for sale	-	(27,810)	-	(258,678)	(286,488)
Balance as at September 30, 2017	$ -	$ 493,462	$ 3,669,053	$ 161,776	$ 4,324,291
Net book value:					
September 30, 2017	$ 141,700	$ 3,378,116	$ 12,253,903	$ 83,279	$ 15,856,998
September 30, 2016	$ 141,700	$ 3,453,250	$ 13,615,447	$ 127,915	$ 17,338,312

Additions, disposals and depreciation for the year ended September 30, 2017 are for continuing operations. The amounts relating to assets held for sale were based on balances as at September 30, 2016.

(Expressed in Canadian dollars)

7. Intangible assets and goodwill:

(a) *Goodwill impairment:*

The Company performs a goodwill impairment test at least annually on September 30 and whenever there is an indication of impairment. No impairment of goodwill was identified as a result of the Company's most recent annual impairment test.

The key assumptions used in performing the impairment tests:

Valuation method	Discount rate		Perpetual growth rate	
	2017	2016	2017	2016
Value in use	12%	12%	1.0% - 2.0%	1.0% - 2.0%

- Recoverable amount:
  Management's past experience and future expectations of the business' performance are used to make a best estimate of the expected revenues, earnings before interest, taxes, depreciation and amortization, and operating cash flows covering a five year forecast period, with a terminal value extrapolated into the future over the estimated useful life of the CGU using a steady growth rate.
- Discount rate:
  The discount rate applied is a pre-tax rate which reflects the time value of money and risk associated with the business. Management has determined its discount rate to reflect the risk of an emerging technology company.
- Perpetual growth rate:
  The perpetual growth rate is management's current assessment of the long-term growth prospect of the Company in the jurisdictions in which it operates.
- Sensitivity analysis:
  Management performs sensitivity analysis on the key assumptions. Sensitivity analysis indicates reasonable changes to key assumptions will not result in an impairment loss.

(Expressed in Canadian dollars)

7. Intangible assets and goodwill (continued):

(b) *Finite life intangible assets:*

Cost:		
Balance as at October 1, 2015	$	5,476,359
Dispositions		(31,405)
Balance as at September 30, 2017 and 2016	$	5,444,954
Accumulated amortization:		
Balance as at October 1, 2015	$	2,750,730
Amortization expense		1,364,390
Dispositions		(31,405)
Balance as at September 30, 2016		4,083,715
Amortization expense		1,361,239
Dispositions		-
Balance as at September 30, 2017	$	5,444,954
Net book value:		
September 30, 2017	$	-
September 30, 2016	$	1,361,239

8. Note payable:

The note payable was fully secured against the assets of the Company. The Company had a requirement to pay interest at a fixed rate of 4% per annum, interest only, with payment of the principal due on September 16, 2017. On August 21, 2017, the note payable was repaid in full and all security released.

9. Convertible debentures:

On June 9, 2016, the Company completed an initial tranche of a non-brokered private placement of unsecured subordinated convertible debentures in the amount of $2,505,000, with a second and final tranche closing on June 21, 2016 in the amount of $1,680,000 for total gross proceeds of $4,185,000, which were payable upon maturity on May 31, 2018.

The convertible debentures accrued interest at a rate of 12% per annum payable quarterly in arrears and were convertible into common shares of the Company at a price of $1.25 per share. The debentures were convertible into shares at the Company's option, at a price equal to their principal amount provided that the Company's common shares traded and closed on the TSXV at or above $2.00 for ten consecutive days any time after four months from issuance.

The Company had the option to pre-pay the principal sum, in whole or in part, twelve months following the closing, after providing twenty business days notice to the holder.

(Expressed in Canadian dollars)

9. Convertible debentures (continued):

The convertible debentures are compound financial instruments and the gross proceeds at the issuance date were allocated between each component of the instrument, first based on fair value of liability and the residual to equity. Transaction costs related to the issuance in the amount of $64,711 were allocated proportionately and each of the components were recorded in the financial statements net of allocated transaction costs. The Company identified three components; a debt-host instrument, an equity conversion option encompassing the holder's option, and the Company's embedded call option.

The Company determined that on the date of issuance, the fair value of the debt-host instrument, determined with reference to market interest rates and credit spreads for similar debt without the equity conversion options, was $3,569,511. The embedded call option was determined to have a fair value of $nil at the issuance date. The remaining value of $615,489 was allocated to the equity conversion option and included in contributed surplus (net of allocated issuance costs) as prescribed under IFRS.

On May 18, 2017, the Company provided notice to the debenture holders of the Company's intention to repay the convertible debentures on June 21, 2017. On May 18, 2017, the Company recorded accretion expense to bring the carrying value of the debentures to face value of $4,185,000.

Several debenture holders elected to convert their debentures into common shares at $1.25 per share. As a result the Company issued 2,252,000 common shares valued at $2,815,000. The remaining $1,370,000 was repaid.

A continuity of the amounts recorded for the total convertible debentures issued and the related equity component was as follows:

	Convertible debentures	Equity component of convertible debentures	Total
Gross proceeds on issuance	$ 3,569,511	$ 615,489	$ 4,185,000
Transaction costs	(55,194)	(9,517)	(64,711)
Net proceeds on issuance	3,514,317	605,972	4,120,289
Deferred tax liability	-	(162,797)	(162,797)
Interest expense	233,352	-	233,352
Interest paid	(152,527)	-	(152,527)
Balance as at September 30, 2016	3,595,142	443,175	4,038,317
Interest expense	945,827	-	945,827
Interest paid	(355,969)	-	(355,969)
Common shares issued	(2,815,000)	-	(2,815,000)
Convertible debentures repaid	(1,370,000)	-	(1,370,000)
Balance as at September 30, 2017	$ -	$ 443,175	$ 443,175

(Expressed in Canadian dollars)

9. Convertible debentures (continued):

Interest expense related to the convertible debentures for the year was as follows:

	Years ended September 30, 2017	2016
Interest paid	$ 355,969	$ 152,527
Accretion of convertible debentures	589,858	80,825
Interest expense	$ 945,827	$ 233,352

10. Share capital:

(a) *Share capital:*

Authorized:

Unlimited number of common shares with no par value

Unlimited number of preferred shares with no par value

Common shares issued and fully paid:

	Number of shares	Amount
Balance as at October 1, 2015	53,387,215	$ 44,666,497
RSUs vested	237,070	258,406
Options exercised	240,000	285,604
Balance as at September 30, 2016	53,864,285	$ 45,210,507
Debentures converted	2,252,000	2,815,000
Private placement	11,586,870	12,486,784
RSUs vested	420,670	567,905
Options exercised	272,000	346,287
Balance as at September 30, 2017	68,395,825	$ 61,426,483

There are no preferred shares issued and outstanding.

On May 18, 2017, the Company completed a bought deal private placement with a syndicate of underwriters pursuant to which the Company issued 11,586,870 common shares at a price of $1.15 per share, for gross proceeds to the Company of $13,324,901. The Company incurred share issue costs of $838,117.

(b) *Share-based payment plans:*

(i) Share option plan

On January 28, 2015, the Company revised its share option plan. Under the plan the maximum number of shares that may be reserved for issuance at any point in time is 7.0% of the outstanding shares.

(ii) Restricted share unit plan

On January 28, 2015, the Company adopted a RSU plan. Under the plan the maximum number of shares that may be reserved for issuance was fixed at 1,500,000. As of February 21, 2017, there were 940,030 RSUs granted but not converted and 216,369 outstanding available for grant. On March 30,

(Expressed in Canadian dollars)

10. Share capital (continued):

(b) *Share-based payment plans (continued):*

(ii) Restricted share unit plan (continued)

2017, shareholders approved an additional 600,000 RSUs available for grant. As at September 30, 2017, 806,169 RSUs remain available to be granted. The obligations under the RSU plan can be settled at the Company's discretion through either cash or issuance of common shares. The Company intends to settle the obligation through the issuance of common shares.

(c) *Stock option plan:*

Stock options outstanding as at September 30, 2017:

	Number of options	Weighted average exercise price
Balance as at October 1, 2015	1,982,000	$ 1.30
Granted	796,500	1.14
Exercised	(240,000)	0.82
Expired	(50,000)	1.70
Balance as at September 30, 2016	2,488,500	$ 1.29
Granted	413,500	1.48
Exercised	(272,000)	0.82
Forfeited or expired	(590,000)	1.42
Balance as at September 30, 2017	2,040,000	$ 1.35

The following table summarizes information pertaining to the Company's stock options outstanding as at September 30, 2017:

	Options outstanding			Options exercisable	
Range of exercise prices	Number of options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
$1.01 - $1.25	976,500	3.18	$ 1.12	850,875	$ 1.14
$1.26 - $1.65	1,063,500	2.43	1.56	919,250	1.58
	2,040,000	2.79	$ 1.35	1,770,125	$ 1.37

The exercise price of all stock options granted during the period are equal to the closing market price at the grant date. The Company calculates the fair value of the options at the grant date using the Black-Scholes option-pricing model with assumptions noted below.

(Expressed in Canadian dollars)

10. Share capital (continued):

(c) *Stock option plan (continued):*

The weighted average assumptions used to estimate the fair value of options granted during the years ended September 30, 2017 and 2016:

	2017	2016
Risk free interest rate	1.21%	0.66%
Expected life	4.4	4.3
Vesting period	1.5 years	1.5 years
Expected volatility	46%	50%
Expected dividends	Nil	Nil
Average fair value	$0.58	$0.47
Forfeiture rate	11.4%	10.2%

The Company charged the following share-based payments to expenses in connection with the Company's stock option plan, with a corresponding increase in contributed surplus:

	2017	2016
Total compensation - stock options	$ 364,649	$ 290,280

(d) *Restricted share unit plan:*

During the year ended September 30, 2016, the Company granted 387,900 RSUs to employees and directors with a fair value of $1.26 per share. 25% of these RSUs vested on September 1, 2016, 35% vested on September 1, 2017, and the remaining 40% will vest on September 1, 2018.

During the year ended September 30, 2017, the Company granted 499,200 RSUs to employees and directors with a weighted average fair value of $1.48 per share. 25% of these RSUs vested on September 1, 2017, 35% will vest on September 1, 2018, and the remaining 40% will vest on September 1, 2019.

RSUs outstanding as at September 30, 2017:

	Number of RSUs
Balance as at October 1, 2015	319,598
Granted	387,900
Forfeited	(19,398)
Vested	(237,070)
Balance as at September 30, 2016	451,030
Granted	499,200
Vested	(420,670)
Balance as at September 30, 2017	529,560

(Expressed in Canadian dollars)

10. Share capital (continued):

(d) *Restricted share unit plan (continued):*

Using an estimated forfeiture rate of 10% for the years ended September 30, 2017 and 2016, the Company charged the following share-based payments to operating expenses in connection with the Company's RSU plan, with a corresponding increase in contributed surplus:

	2017	2016
Total compensation - RSUs	$ 556,549	$ 371,506

(e) *Warrants:*

Warrants outstanding as at September 30, 2017:

	Number of warrants	Weighted average exercise price
Balance as at September 30, 2016	1,327,500	$ 1.50
Expired, February 26, 2017	(1,327,500)	1.50
Balance as at September 30, 2017	-	$ -

11. Capital risk management:

The Company's objectives and policies for managing capital are to maintain a strong capital base to maintain investor, creditor and market confidence, sustain future development of the business and to safeguard the Company's ability to support the Company's normal operating requirements on an ongoing basis.

The capital of the Company consists of the items included in the Consolidated Statements of Financial Position in the shareholders' equity section, the secured note payable and convertible debenture. The Company manages its capital structure and makes changes based on economic conditions, risks that impact the consolidated operations and future significant capital investment opportunities. To manage the Company's capital requirements, the Company has in place a planning and budgeting process which helps determine the funds required to ensure the Company has the appropriate liquidity to meet its operating and growth objectives. The Company's officers are responsible for managing the Company's capital and do so through quarterly meetings and regular review of financial information. The Board of Directors is responsible for overseeing this process.

12. Financial instruments and risk exposures:

(a) *Fair value measurement:*

The Company's financial assets include cash and cash equivalents and accounts receivable. The Company's financial liabilities include accounts payable and accrued liabilities, secured note payable and convertible debentures.

Cash and cash equivalents and accounts receivable are classified as loans and receivables, measured at amortized cost using the effective interest rate method. Accounts payable and accrued liabilities, secured note payable, and the convertible debentures are classified as other financial liabilities, measured at amortized cost using the effective interest rate method. The effective interest rate is the rate that exactly

(Expressed in Canadian dollars)

12. Financial instruments and risk exposures (continued):

(a) *Fair value measurement (continued):*

discounts the estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or liability.

The carrying value of the Company's financial assets and liabilities is considered to be a reasonable approximation of fair value due to their immediate or short-term maturity, or their ability for liquidation at comparable amounts.

(b) *Credit risk:*

Credit risk is the risk of a financial loss if a customer or counterparty to a financial instrument fails to meet its obligations under a contract. This risk primarily arises from the Company's receivables from customers.

The Company's exposure to credit risk is dependent upon the characteristics of each customer. Each customer is assessed for credit worthiness, using third party credit scores and through direct monitoring of their financial well-being on a continual basis. In some cases, where customers fail to meet the Company's credit worthiness benchmark, the Company may choose to transact with the customer on a prepayment basis or to seek other means of guarantees.

The Company does not have credit insurance or other financial instruments to mitigate its credit risk as management has determined that the exposure is minimal due to the composition of its customer base.

The Company regularly reviews the collectability of its accounts receivable and establishes an allowance account for credit losses based on its best estimate of any potentially uncollectable accounts. As at September 30, 2017, the balance of the allowance account for credit losses was $nil (2016 - $nil).

Pursuant to their respective terms, accounts receivable was aged as at September 30, 2017 and 2016:

	2017	2016
0 – 30 days	$ 754,381	$ 399,771
31 – 60 days	397,102	57,638
61 – 90 days	-	140,005
Greater than 90 days	222,959	-
Total accounts receivable	$ 1,374,442	$ 597,414

Accounts receivable greater than 90 days are collectible from government agencies.

There is a possibility of increased customer credit risk due to the ongoing global recessionary trends. As at September 30, 2017, the Company's accounts receivable are made up of approximately 70% (2016 - 37%) government trade receivables and the balance of the outstanding accounts receivable are spread over several other customers.

During the year ended September 30, 2017, the Company had two customers who represented greater than 10% of total revenues. These customers represented approximately 75% and 21% of total revenues (2016 - two customers represented approximately 32% and 14%).

The Company may also have credit risk relating to cash and cash equivalents, which it manages by dealing with large banks and investing in highly liquid investments. The Company's objective is to minimize its

12. Financial instruments and risk exposures (continued):

(b) *Credit risk (continued):*

exposure to credit risk in order to prevent losses on financial assets by placing its investments in highly liquid instruments such as guaranteed investment funds. The Company's cash and cash equivalents carrying value as at September 30, 2017 totaled $10,883,919 (2016 - $3,312,691), and accounts receivables of $1,374,442 (2016 - $597,414), representing the maximum exposure to credit risk of these financial assets.

(c) *Liquidity risk:*

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due.

The Company has in place a planning and budgeting process which helps determine the funds required to ensure the Company has the appropriate liquidity to meet its operating and growth objectives.

As at September 30, 2017, the Company had cash and cash equivalents of $10,883,919 (2016 - $3,312,691) and accounts receivable of $1,374,442 (2016 - $597,414) for a total of $12,258,361 (2016 - $3,910,105). The liquidity and additional financing are adequate for the settlement of short-term financial obligations.

(d) *Currency risk:*

Currency risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate due to changes in foreign exchange rates.

The Company is exposed to currency risk as a result of components of cost being denominated in currencies other than the Canadian dollar, primarily the United States dollar. The Company holds cash and has liabilities (primarily accounts payable and accrued liabilities) in currencies other than the Canadian dollar, primarily the United States dollar. In addition, the Company also has United States dollar denominated accounts receivable that are subject to currency risk.

The Company manages currency risk by holding cash in foreign currencies to support forecasted foreign currency denominated liabilities and does not use derivative instruments to reduce its exposure to foreign currency risk.

(e) *Interest rate risk:*

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company's exposure to the risk of changes in market interest rates relate primarily to the secured note payable. The Company does not enter into any interest rate swaps to mitigate interest rate risk.

(Expressed in Canadian dollars)

13. Income taxes:

(a) *Income tax expense:*

Income tax expense differs from the expected expense if the Canadian federal and provincial statutory income tax rates were applied to earnings from continuing operations before income taxes. The principal factors causing these differences are shown below:

	2017	2016
Loss from continuing operations before income taxes	$ (3,853,853)	$ (7,992,602)
Statutory tax rate	26.53%	26.45%
Expected tax recovery	(1,022,427)	(2,114,043)
Effective tax rate change and other	(30,450)	(137,202)
Permanent differences	260,525	182,051
Changes recognized in equity	(224,463)	-
Change in unrecognized deferred tax assets	1,016,815	1,906,397
Income tax recovery	$ -	$ (162,797)

The recovery represents a deferred income tax recovery and is a result of the application of the Company's previously unrecognized deferred tax assets subsequent to the issuance of the convertible debentures by the Company in June 2016.

(b) *Recognized deferred tax assets and liabilities:*

The Company has recognized deferred taxes in respect of the following:

	2017	2016
Deferred tax assets:		
Non-capital losses carried forward	$ 2,890,617	$ 3,241,390
Deferred tax liabilities:		
Property, plant, and equipment and intangible assets	(2,890,617)	(3,085,593)
Convertible debentures	-	(155,797)
Net deferred tax asset	$ -	$ -

(c) *Deferred income tax assets and liabilities:*

The Company did not recognize deferred tax assets for the following deductible temporary differences:

	2017	2016
Non-capital loss carry forwards	$ 8,789,958	$ 8,386,489
Net capital loss carry forwards	2,385,221	2,385,221
Other temporary differences	8,223,233	6,398,843
Unrecognized deferred income tax assets	$ 19,398,412	$ 17,170,553

(Expressed in Canadian dollars)

13. Income taxes (continued):

(d) *Loss carry forwards:*

As at September 30, 2017, the Company has Canadian tax loss carry forwards of approximately $19,583,000 (2016 - $19,160,000). The Company's tax loss carry forwards will expire, if not utilized, commencing in 2026. The Company recognizes the benefit of tax losses only to the extent of anticipated future taxable income in the relevant jurisdiction.

(e) *Discontinued operations:*

As at September 30, 2017, the Company has United States loss carry forwards of approximately $2,248,000 (2016 - $1,390,000). A deferred tax asset is not recognized on the benefit of tax losses based on management forecast of future profitability of the operations in the United States.

(f) *R&D and tax credit attributes:*

As at September 30, 2017, the Company had unclaimed tax deductions of scientific research and experimental development expenditures of $1,908,000 (2016 - $1,550,000) that is available to reduce taxable income in future years and may be carried forward indefinitely. As at September 30, 2017, the Company has federal investment tax credits of $418,000 (2016 - $340,000) that may be carried forward to apply against future years' income tax payable. These investment tax credits begin to expire in 2030.

14. Related party transactions:

(a) *The remuneration of key management personnel:*

	2017	2016
Salaries, accrued bonuses, and employee benefits	$ 1,233,741	$ 1,110,792
Share-based payments	699,138	487,925
	$ 1,932,879	$ 1,598,717

(b) As of September 30, 2017, amounts owing to a company controlled by an officer and director of the Company included in accounts payable and accrued liabilities were $262,854 (2016 - $285,509).

(c) Legal and professional fees, taxes and disbursements totaling $160,664 for the year ended September 30, 2017 (2016 - $137,059) were incurred with a law firm of which a director of the Company is a partner. As of September 30, 2017, amounts owing to this company included in accounts payable and accrued liabilities were $93,219 (2016 - $52,826).

(d) During the year ended September 30, 2016, certain directors and officers of the Company participated in the convertible debenture financing amounting to $350,000.

The above transactions are in the normal course of business and are measured at the exchange amount which is the amount of consideration established and agreed to by the related parties.

(Expressed in Canadian dollars)

15. Supplementary cash flow information:

(a) *Change in non-cash working capital:*

	2017	2016
Accounts receivable	$ (904,902)	$ 373,423
Inventory	150	601,496
Prepaid expenses and other assets	(85,143)	(50,745)
Accounts payable and accrued liabilities	112,304	(553,151)
Deferred revenue	157,171	-
	$ (720,420)	$ 371,023

(b) *Interest and income taxes:*

During the year ended September 30, 2017, the Company paid $461,980 in interest (2016 - $276,253). The Company did not pay any income taxes during the years ended September 30, 2017 and 2016.

(c) *Cash and cash equivalents:*

Cash and cash equivalents are comprised of:

	September 30, 2017	September 30, 2016
Cash	$ 914,378	$ 644,490
Term deposit	9,969,541	2,668,201
	$ 10,883,919	$ 3,312,691

(d) *Supplemental disclosure of non-cash financing activities:*

	September 30, 2017	September 30, 2016
Shares issued on conversion of convertible debentures (note 9)	$ 2,815,000	$ -

16. Nature of expenses:

The expenses presented below represent total cost of sales, sales and marketing, research and development, general and administration expenses, and depreciation and amortization.

	2017	2016
Salaries and benefits	$ 3,452,013	$ 3,213,635
Share-based compensation	921,198	661,786
Depreciation and amortization	2,916,283	3,077,997
Travel and entertainment	282,233	425,196
Professional fees and insurance	613,837	811,591
Public company costs	668,058	626,788
Rent and utilities	520,957	675,372
Maintenance and office expenses	278,353	192,320
Materials consumed	360,118	592,405
	$ 10,013,050	$ 10,277,090

(Expressed in Canadian dollars)

17. Commitments:

(a) As at September 30, 2017, the Company is committed under operating leases, primarily related to office space, and capital equipment purchases for the following amounts:

2018	$	2,288,093
2019		200,654
2020		117,048
	$	2,605,795

(b) Certain nano-optic products are subject to a 3% sales royalty in favor of Simon Fraser University where certain elements of the nano-optic technology originated. No royalties were paid during the year (2016 - $nil).

18. Discontinued operations:

On September 21, 2017, the Directors of the Company made the determination that it would pursue the possible sale of the assets of its subsidiary, TTI, to a third party. The Company is actively pursuing potential purchasers and has engaged a business broker to pursue interested parties. At September 30, 2017, TTI was classified as a separate disposal group held for sale and as a discontinued operation.

The major classes of assets and liabilities of TTI classified as held for sale as at September 30, 2017 are as follows:

Cash	$	30,280
Accounts receivable		116,538
Inventory		54,525
Prepaid expenses		12,401
Property, plant and equipment		2,481
Assets held for sale	$	216,225
Accounts payable and accrued liabilities	$	200,226
Liabilities directly associated with assets held for sale	$	200,226
Cumulative loss in accumulated other comprehensive loss	$	(68,905)

(Expressed in Canadian dollars)

18. Discontinued operations (continued):

Net loss on discontinued operations, net of income taxes, is as follows:

	2017	2016
Revenue	$ 1,259,066	$ 2,237,213
Cost of sales	874,133	1,419,855
Gross Profit	384,933	817,358
Expenses		
Research and development	269,310	321,042
General and administration	542,227	366,575
Sales and marketing	246,630	290,646
Depreciation	12,804	3,774
	1,070,971	982,037
Loss before other expenses	(686,038)	(164,679)
Other expense		
Finance costs	3,465	6,216
Loss on remeasurement to fair value less costs to dispose	210,776	-
	214,241	6,216
Net loss from discontinued operations	$ (900,279)	$ (170,895)
Other comprehensive income (loss):		
Unrealized foreign exchange gain on translation of foreign operation	85,605	24,654
Net comprehensive loss from discontinued operations	$ (814,674)	$ (146,241)

Net cash flows from discontinued operations activities amounted to $(574,313) (2016 - $(245,182)).