



September 30, 2019

ANNUAL REPORT



Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

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 2019 mean the fiscal year ended September 30, 2019. Last year and 2018 mean the fiscal year ended September 30, 2018, and 2017 means the fiscal year ended September 30, 2017. This quarter or the current quarter means the three months ended September 30, 2019.

ADVISORY

This MD&A, dated December 11, 2019, 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, 2019. 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 the loss of a key customer, that the Company's products receive market acceptance and 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 the MD&A and the notes to the audited consolidated financial statements for the year ended September 30, 2019, 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, 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 #1200 - 200 Burrard Street, Vancouver, BC, Canada V7X 1T2.

Nanotech researches, creates, and produces nano-optic structures and colour-shifting materials used in authentication and brand enhancement applications across a wide range of markets including banknotes, tax stamps, secure government documents, and commercial branding.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

The Company's nano-optic technology employs arrays of billions of nano-indentations that can be impressed or embossed onto a wide range of substrate materials including polymer, paper, metal, or fabric. By using sophisticated algorithms to direct an electron beam lithography system, the Company creates visual images with effects such as 3D, perceived movement, and the display of high-definition colours.

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 Board of Directors made the determination that the Company would pursue the possible sale of its subsidiary, Tactical Technologies Inc. ("Tactical"), to a third party. At September 30, 2017, Tactical was classified as a separate disposal group held for sale and as a discontinued operation.

On June 29, 2018, the assets used in connection with Tactical's surveillance equipment and van conversion business were sold to an employee of Tactical for a nominal amount, and on September 28, 2018, Tactical was dissolved and struck from the corporate register.

Report on 2019 Strategic Initiatives

In 2019, the Company shifted its focus to near-term revenue growth by commercializing its technology into products specifically designed for the banknote and secure document market and for the brand protection market. The Company expanded its sales and marketing team with the addition of experienced sales leaders to pursue near-term revenue opportunities in both of its key markets.

Banknote security feature market. The Company has two areas of focus in the banknote market:

1. **Advancement of contract services for a G10 central bank.** The confidential customer, a central bank, confirmed in July that the security feature developed by Nanotech will advance to the next stage, which involves demonstrating that the security feature can be manufactured. While the Company does not currently have visibility on if or when Nanotech's feature might be integrated into the customer's banknotes, the Company has made major advancements in its development of a unique and novel security feature in 2019.
2. **Expansion of Nanotech's security feature product line.** The Company successfully pursued new sales opportunities for OTF in the banknote and secure documents market. As announced on August 1, 2019 and September 10, 2019, the Company expanded its business with two long-term OTF customers in 2019. In addition, Nanotech developed KolourDepth™, a new banknote security feature using the Company's nano-optic technology that was launched on October 1, 2019.

Brand protection market. The Company launched its first brand protection products, LiveLogo™ and LivePortrait™ in April and completed its first sale in the brand protection market this year. The sales team participated in targeted industry tradeshows and events to promote Nanotech's brand protection product line. Nanotech's products have garnered strong interest from the industry, with several opportunities added to the sales pipeline and the announcement of a multi-year brand protection contract subsequent to year end.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

RESULTS OF OPERATIONS

Select financial information for the years ended September 30, 2019, 2018 and 2017:

Select Financial Information	2019	2018	2017
Revenue ⁽¹⁾	\$ 6,402,702	\$ 8,247,414	\$ 7,116,291
Cost of sales ⁽¹⁾	1,511,865	1,510,101	1,429,371
	4,890,837	6,737,313	5,686,920
Expenses			
Research and development	1,477,668	1,407,430	1,475,437
General and administration	2,307,021	2,532,156	2,308,846
Sales and marketing	2,161,056	2,018,055	2,043,514
Depreciation and amortization	1,481,388	1,485,024	2,755,882
Restructuring costs	787,575	-	-
	8,214,708	7,442,665	8,583,679
Loss from continuing operations before other expenses	(3,323,871)	(705,352)	(2,896,759)
Other (income) expenses ⁽¹⁾	(488,617)	(782,408)	957,094
Income (loss) from continuing operations before income taxes	(2,835,254)	77,056	(3,853,853)
Net income (loss) from continuing operations	(2,835,254)	77,056	(3,853,853)
Loss from discontinued operations	-	(123,322)	(900,279)
Net loss	\$ (2,835,254)	\$ (46,266)	\$ (4,754,132)
Adjusted EBITDA ⁽²⁾	\$ (118,519)	\$ 1,998,785	\$ 1,168,222

⁽¹⁾Revenue, cost of sales and other income for 2018 and 2017 have been adjusted to reflect the reclassification of tenant and steam income from revenue to other income under the full retrospective application of IFRS 15 – *Revenue from Contracts with Customers*, which was adopted October 1, 2018. Quarterly revenue adjusted for these reclassifications can be found in the “Quarterly Results” section of this MD&A. For further information, see note 4(b) of the consolidated financial statements for the year ended September 30, 2019.

⁽²⁾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	2019	2018	2017
Cash, cash equivalents and short-term investments	\$ 10,289,264	\$ 9,613,621	\$ 10,883,919
Total assets	\$ 28,523,244	\$ 30,229,055	\$ 30,059,624
Total liabilities	1,791,610	1,325,139	1,860,086
Total equity	26,731,634	28,903,916	28,199,538

Revenue

The Company currently derives the majority of its revenue from contract services with a G10 central bank. During the year ended September 30, 2017, the Company disclosed a development contract for up to \$30.0 million over a period of up to five years. These contract services incorporate both nano-optic and OTF technologies and are focused on developing authentication features for future banknotes. There is inherent variability in the timing and scope of contract services, particularly as the Company transitions from the development of security features toward production of a final selected security feature. While the Company is progressing toward the goal of incorporating a Nanotech security feature on this customer's banknote, advancement towards this goal corresponds with the customer narrowing the scope of development activities with an intention to select a final security feature. Although focusing on one security feature is a positive development, revenues from this customer are variable and there was a decline in the year ended September 30, 2019, compared to the same period last year.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

Revenue for the year ended September 30, 2019 decreased by \$1,844,712 or 22% to \$6,402,702, compared to \$8,247,414 in the same period last year primarily due to reduced contract services revenue in the current period, partially offset by increased revenue from products.

Gross Margin

Gross margin for the year ended September 30, 2019 decreased by \$1,846,476 or 27% to \$4,890,837, compared to \$6,737,313 in the same period last year. Overall, the gross margin percentage was 76% for the year ended September 30, 2019, a decrease from 82% in the same period last year primarily due to the decrease in higher margin contract services revenue in the current period.

Research and Development

Research and development expenditures for the year ended September 30, 2019 increased by \$70,238, or 5% to \$1,477,668 compared to \$1,407,430 in the same period last year. This increase was primarily due to increased equipment maintenance costs and the write-down of inventory in the current year, partially offset by reduced patent expenses in the current period due to timing of patent filings.

General and Administration

General and administration expenditures for the year ended September 30, 2019 decreased \$225,135, or 9% to \$2,307,021 compared to \$2,532,156 in the same period last year. The decrease was primarily due to executive transition in 2019, partially offset by an increase in professional fees and rent expense in the current period.

Sales and Marketing

Sales and marketing expenditures for the year ended September 30, 2019 were \$2,161,056, an increase of \$143,001 or 7% compared to \$2,018,055 in the same period last year. The increase was related to salary expenses as headcount was higher in the current period and increased marketing expenditures, partially offset by reduced investor relations expenses in the current period.

Depreciation and Amortization

Depreciation and amortization included in operating expenditures for the year ended September 30, 2019 was \$1,481,388, compared to \$1,485,024 in the same period last year. Depreciation included in cost of sales for the year ended September 30, 2019 was \$84,734, compared to \$128,146 for the same period last year, which reflects higher sales in the previous year.

Restructuring Costs

On December 21, 2018, the Board implemented an executive transition plan, under which Mr. Doug Blakeway, the former CEO, transitioned his responsibilities to Mr. Troy Bullock. Under the terms of this transition plan, Mr. Blakeway's executive services consulting agreement was terminated, triggering early termination benefits as laid out in the agreement: two years base salary, a pro-rated performance bonus, and vesting of all outstanding share-based awards. The Company incurred restructuring costs of \$787,575 as at September 30, 2019 (September 30, 2018 - \$nil), of which \$92,200 represented share-based compensation related to the accelerated vesting of Mr. Blakeway's restricted share units ("RSUs").

In January 2019, termination benefits were paid and 187,500 shares were issued to Mr. Blakeway upon vesting of his RSUs. Restructuring costs of \$84,375 remain accrued as at September 30, 2019 (September 30, 2018 - \$nil).

Other Income

Other income for the year ended September 30, 2019 was \$488,617, a decrease of \$293,791, compared to other income of \$782,408 in the same period last year. The decrease was primarily due to a reduced foreign exchange gain in the current period as a result of higher fluctuations in foreign exchange in the prior year. In addition, other income from rent and steam decreased compared to the prior year as the tenant renting warehouse space in the Thurso facility experienced financial difficulties, resulting in a write down of certain rent and steam receivables. This decrease in the other income was partially offset by increased finance income due to higher interest rates in the current year.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

Adjusted EBITDA

Adjusted EBITDA for the year ended September 30, 2019 was negative \$118,519, compared to positive \$1,998,785 during the same period last year. The decrease was primarily due to reduced revenue and margins in the current year.

Net Loss

Net loss for the year ended September 30, 2019 was \$2,835,254, compared to a net loss of \$46,266 during the same period last year. The increase in net loss was primarily due to decreased revenue in the current period in combination with restructuring costs related to the executive transition.

QUARTERLY RESULTS

	Q4 2019	Q3 2019	Q2 2019	Q1 2019	Q4 2018	Q3 2018	Q2 2018	Q1 2018
(\$ thousands, except per share data)								
Revenue ⁽¹⁾	\$ 1,450	\$ 1,827	\$ 1,594	\$ 1,532	\$ 3,000	\$ 1,769	\$ 1,486	\$ 1,992
Net income (loss) from continuing operations	(705)	(521)	(477)	(1,132)	770	(456)	(333)	96
Net income (loss)	(705)	(521)	(477)	(1,132)	770	(627)	(285)	96
Adjusted EBITDA ⁽²⁾	(299)	17	45	118	1,306	100	133	460
Basic earnings (loss) per share:								
Continuing operations	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00	0.00
Net income (loss)	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00	0.00
Diluted earnings (loss) per share:								
Continuing operations	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00	0.00
Net income (loss)	(0.01)	(0.01)	(0.01)	(0.02)	0.01	(0.01)	0.00	0.00

⁽¹⁾ Revenue has been adjusted to reflect the full retrospective application of IFRS 15, which was adopted October 1, 2018. Revenue for the previous seven quarters has been adjusted from the quarterly filings to reflect the reclassification of steam from revenue to other income under IFRS 15. For further information, see note 4(b) of the consolidated financial statements for the year ended September 30, 2019.

⁽²⁾ Adjusted EBITDA is a non-IFRS measure as described in the "Non-IFRS Financial Measures" section of this MD&A.

Revenue and Adjusted EBITDA were impacted by the timing and scope of contract services and the timing of recurring OTF orders in the quarters presented. There is an inherent variability in contract revenue with government organizations and in the receipt of recurring OTF orders. Net income (loss) from continuing operations and net income (loss) were further affected by restructuring costs in the first quarter of 2019. There are no seasonal effects in the Company's business over the quarters presented.

Comparison of Fourth Quarter Results, Year-over-year

Revenue for the fourth quarter of 2019 was \$1,449,687, compared to \$3,000,839 in the same period of 2018. The decrease is primarily due to decreased contract services revenue in the current quarter, which was a result of the inherent variability in timing of development contract revenue.

Net loss from continuing operations for the fourth quarter of 2019 was \$704,848, compared to net income of \$770,086 in the fourth quarter of 2018. Revenue decreased in the current quarter, while sales and marketing and research and development expenses increased in the current quarter.

Adjusted EBITDA for the fourth quarter of 2019 was negative \$298,542, compared to positive \$1,305,841 in the same period of 2018. The difference is primarily due to decreased revenue in the current quarter.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

RELATED PARTY TRANSACTIONS

For the year ended September 30, 2019, 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) *The remuneration of key management personnel*

	2019	2018
Salaries, accrued bonuses, employee benefits and director fees	\$ 712,298	\$ 1,330,306
Share-based payments	255,476	493,881
Restructuring costs	787,575	-
	<u>\$ 1,755,349</u>	<u>\$ 1,824,187</u>

(b) As at September 30, 2019, amounts owing to a company controlled by a director of the Company included in accounts payable and accrued liabilities were \$90,938 (2018 - \$191,433). These payables represent amounts owing under the terms of an executive services consulting agreement, including payments owing upon early termination of this agreement.

(c) Legal and professional fees, taxes and disbursements totaling \$42,485 for the year ended September 30, 2019 (2018 - \$81,776) were incurred with a law firm of which a director of the Company is a partner. As at September 30, 2019, amounts owing to this company included in accounts payable and accrued liabilities were \$nil (2018 - \$50,780). During the year ended September 30, 2019, the Company retained new legal counsel and moved its registered and records office.

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 any potential shortfall from operations, working capital, and capital expenditures. Cash is also used to finance other long-term strategic business initiatives.

Summary of Statements of Cash Flows

	2019	2018
Cash provided by continuing operations	\$ 942,269	\$ 1,453,736
Cash provided by (used in) discontinued operations	(16,204)	76,694
Cash provided by operating activities	926,065	1,530,430
Cash used in investing activities	(187,814)	(10,300,677)
Effect of foreign exchange on cash and cash equivalents	(1,013)	(98,908)
Cash and cash equivalents, beginning of year	2,014,764	10,883,919
Cash and cash equivalents, end of year	<u>\$ 2,752,002</u>	<u>\$ 2,014,764</u>

Operating Activities

Cash provided by operating activities was \$926,065 for the year ended September 30, 2019, compared to cash provided by operating activities of \$1,530,430 for the same period last year. The difference was a result of increased net loss during the current period, offset by a decrease in accounts receivable in the current period.

Investing Activities

Cash used in investing activities was \$187,814 for the year ended September 30, 2019, compared to \$10,300,677 used in the same period last year. The current period represents investment in minor capital

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

projects and the net disposal of short-term investments, whereas the prior period reflects the purchase of an electron beam lithography system, a steam boiler, and an embossing line, as well as the acquisition of short-term investments.

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 to 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 operations, and future significant capital investment opportunities. For the year ended September 30, 2019, there were no changes in our approach to capital management.

	2019	2018
Cash	\$ 752,911	\$ 292,688
Cash equivalents	1,999,091	1,722,076
Short-term investments	7,537,262	7,598,857
	\$ 10,289,264	\$ 9,613,621

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

The Company had commitments of \$997,732 as at September 30, 2019, primarily under operating leases related to office space and contracted equipment maintenance. Subsequent to September 30, 2019, the Company renewed office leases for a 5-year term ending in 2025.

Management has reviewed its projected funding requirements for the next 12 months and expects that, through the generation and collection of revenues, the Company will maintain sufficient liquidity to meet its requirements.

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 income (loss) excluding the impact of interest and financing costs (net of interest income), foreign exchange gain (loss), income taxes, depreciation and amortization, share-based compensation, restructuring costs and net income (loss) from discontinued operations. The Company believes Adjusted EBITDA is a useful measure as 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, as well as fund future growth. Adjusted EBITDA may also be used by investors and analysts for the purpose of valuing the Company.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

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 Nanotech's 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.

	2019	2018
Net loss	\$(2,835,254)	\$(46,266)
Finance income	(192,752)	(121,878)
Foreign exchange gain	(14,982)	(250,023)
Restructuring costs	787,575	-
Depreciation and amortization	1,566,122	1,611,891
Share-based compensation	570,772	681,739
Net loss from discontinued operations	-	123,322
Adjusted EBITDA	\$ (118,519)	\$ 1,998,785

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 13 of the consolidated financial statements for the year ended September 30, 2019. In the year ended September 30, 2019, 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 an RSU plan to grant options and RSUs to eligible participants. 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, 2019, 1,677,500 options (2018 – 567,500) and 298,640 RSUs (2018 – 238,782) were granted. During the year ended September 30, 2019, 15,120 RSUs and 750,000 options (2018 – 22,060 RSUs and nil options) were forfeited or expired during the year.

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

	September 30, 2019		September 30, 2018	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Common shares outstanding	69,200,125		68,771,501	
Options				
Outstanding	3,535,000	\$ 0.95	2,607,500	\$ 1.35
Exercisable	2,628,750	\$ 1.05	2,273,750	\$ 1.35
RSUs				
Outstanding	225,502	N/A	370,606	N/A

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

As at September 30, 2019, the following RSUs were available to grant:

Total RSUs approved by shareholders	2,700,000
Shares issued to date under the RSU plan	(1,568,571)
Reserved for issuance under the RSU plan	1,131,429
RSUs outstanding	(225,502)
RSUs available to grant	905,927

As at September 30, 2019, the following options were available to grant:

10.0% of common shares issued and outstanding	6,920,012
Shares reserved for issuance under the RSU plan	(1,131,429)
Options outstanding	(3,535,000)
Options available to grant	2,253,583

As at December 11, 2019, the Company has 69,200,125 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 these 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, 12 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.

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 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

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

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.

The Company performs impairment tests for goodwill and other non-financial 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 revenue growth rates. Changes in estimates and assumptions can affect the reported value of goodwill and other non-financial assets.

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 award 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. 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

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

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 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.

CHANGE IN ACCOUNTING POLICY

(a) IFRS 9 – Financial Instruments

In July 2014, the IASB issued IFRS 9 – *Financial Instruments*, which replaces 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 and a single, forward-looking 'expected credit loss' impairment model.

The Company adopted IFRS 9 on October 1, 2018. The adoption of IFRS 9 did not have an impact on the Company's consolidated financial statements and related disclosures. With respect to classification and measurement, the Company has applied the exemption not to restate comparative information for prior periods. The determination of the business model within which a financial asset is held has been made on the basis of facts and circumstances that existed at the date of initial application.

The following table explains the original measurement categories under IAS 39 and the new measurement categories under IFRS 9 for each class of financial assets as at October 1, 2018.

Financial assets	IAS 39	IFRS 9
Cash and cash equivalents	Loans & receivables	Amortized cost
Short-term investments	Loans & receivables	Amortized cost
Trade and other receivables	Loans & receivables	Amortized cost

There was no change in classification of financial liabilities as a result of the adoption of IFRS 9. There are no differences in the carrying amounts of financial assets and financial liabilities resulting from the adoption of IFRS 9.

(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.

The Company adopted IFRS 15 on October 1, 2018. Its adoption did not have a material impact on the Company's consolidated financial statements and related disclosures, except for the reclassification of tenant and steam income, as described below. The Company has applied IFRS 15 in accordance with the full retrospective transitional approach without applying any practical expedients.

IFRS 15 requires entities to recognize revenue when 'control' of goods or services transfers to the customer whereas the previous standard, IAS 18, required entities to recognize revenue when the 'risks and rewards' of goods or services transfer to the customer. The Company concluded there is no change in the timing of

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

revenue recognition under IFRS 15 compared to the previous standard as the point of transfer of risks and rewards of goods and services and transfer of control occur at the same time. However, the Company identified that tenant and steam income do not arise from the entity's ordinary activities, and therefore does not meet the definition of revenue under IFRS 15. As a result, tenant and steam income has been reclassified to other income retrospectively.

For the year ended September 30, 2018, revenue was previously reported as \$9,199,710 and restated as \$8,247,414, due to a reclass of \$257,548 to tenant income and \$694,748 to steam income. Cost of sales was previously reported as \$2,051,890 and restated as \$1,510,101, due to a reclass of \$19,725 to tenant income and \$522,064 to steam income. There was no impact on net loss and loss per share.

(c) Other

The Company has adopted narrow scope amendments/interpretations to IFRIC 22 – *Foreign Currency Transactions and Advance Consideration* and IFRS 2 – *Share Based Payments*, which did not have an impact on the Company's consolidated financial statements.

NEW STANDARDS AND INTERPRETATIONS NOT YET ADOPTED

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 will adopt the standard on October 1, 2019, using the modified retrospective approach. The modified retrospective approach applies the requirements of the standard retrospectively with the cumulative effects of initial application recorded in opening accumulated deficit as at October 1, 2019, and no restatement of the comparative period.

Based on the information available at September 30, 2019, as a result of the initial application of IFRS 16 as at October 1, 2019, the Company anticipates recognizing the following on its statement of financial position: right-of-use assets of approximately \$800,000 (including approximately \$16,000 tenant inducement), and a lease liability of approximately \$816,000. The right-of-use assets will be depreciated on a straight-line basis over the remaining lease term. The lease liability will be carried at amortized cost with a finance charge recorded from the amortization of the lease liability discount. The depreciation expense of the right-of-use assets and the finance charge of the lease liability will partially replace the lease-related expenses recorded in general and administration expense.

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

Nanotech continues to be an expenditure-based entity which has incurred substantial losses since inception and may continue to incur losses and experience negative cash flows. The Company cannot predict if or when it will operate profitably, reliably generate positive cash flows, or be able to implement its business strategy successfully. Pursuit of the business strategy requires Nanotech to incur significant expenditures for research and product development, marketing, and general administrative activities. As a result, there is a need to continue to grow revenues and gross margins to achieve and sustain profitability and positive operating cash flows, and the Company may need to raise additional capital.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

Financing Arrangements

Execution of the business plan and commercial viability could be jeopardized if Nanotech is unable to raise additional funds for working capital, R&D projects, sales, marketing and product development activities, as well as other business opportunities. Mitigation of this risk is attempted 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 the Company's commercial products.

If the cash generated from the Company's business becomes 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.

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 required regulatory approvals, 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 employees, 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 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.

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.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

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 terms allocating risk between the manufacturer and its customers.

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, level of government spending, the cyclical nature of capital markets, and political decisions may adversely influence the Company's sales or the Company's ability to access certain funding.

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.

Market Acceptance

The Company cannot accurately predict whether its products and services will achieve significant market acceptance or whether there will be a market for its products and services on terms the Company finds acceptable. Market acceptance of the Company's products and services depends on a number of factors, including the quality, sophistication, price and availability of substitute products and services. Lack of significant market acceptance, delays in acceptance, failure of certain markets to develop or the Company's need to make significant investments to achieve acceptance by the market would negatively affect its business, financial condition and results of operations.

Customer Dependence and Concentration

In 2019, two customers represented 80% and 14% respectively of our total revenues (2018 – one customer represented 81% of total revenues). The loss of a significant customer or any significant contract cancellations could negatively affect revenue and results of operations.

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 awards, failure to exercise contract options, 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 operations.

Quality Issues and Contract Performance

The Company develops, manufactures, and sells technologically advanced complex products that could contain defects in design, manufacture and implementation. 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

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

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.

Manufacturing

The Company has limited experience manufacturing KolourOptik products on a commercial scale. The Company outsources certain parts of the manufacturing process to a limited number of third parties and depends on these manufacturers to meet the Company's needs in a timely and satisfactory manner at a reasonable cost. Disruptions in the supply chain and manufacturing process could negatively affect the Company's revenues, costs, and margins.

The OTF manufacturing process is completed in-house at the Thurso facility. This facility is dependent upon electricity supplied by a neighbouring pulp mill owned by Fortress Global Enterprises ("Fortress"). Recent events, such as Fortress' corporate news and going concern note, indicate that there is a risk that the pulp operations will be curtailed for a significant period of time. At this time management believes it is very unlikely that the electrical supply will be disrupted. However, a disruption in the supply of electricity from Fortress could have a material adverse effect on costs and cash flows, as temporary electricity generation solutions may be costly and an independent electrical solution may require significant capital investment in equipment with long order lead times.

Security Environment

Many of the Company's customers have specific security requirements relating to the work that can be performed for them. These requirements can change quickly and with little notice causing a 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.

Cyber Security

The Company faces the risk of a security breach or other significant disruption of its IT networks and related systems, whether through cyber-attack or cyber intrusion via the internet, malware, computer viruses and email attachments to persons with access to the Company's systems. Security breaches or other significant disruptions of the Company's IT networks and related systems could have a material adverse effect on the Company's business and results of operations.

Although the Company makes significant efforts to maintain security and the integrity of its IT networks and related systems, there can be no assurance that its security efforts and measures will be effective or that attempted security breaches or disruptions will not be successful or damaging. The Company may also need to expend significant resources to protect against security breaches.

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 which 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 may 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 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.

Nanotech Security Corp.

Management's Discussion and Analysis
For the year ended September 30, 2019

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.

ADDITIONAL INFORMATION

2020 Outlook

In 2020, the Company will pursue revenue growth by focusing on product sales opportunities with short sales cycles in both key markets. Management has set the following targets for 2020:

- **Develop strategic sales relationships.** The Company will expand its sales reach by partnering with more established OEMs in both the banknote and brand protection market to promote Nanotech's products to their existing customer bases.
- **Develop strategic manufacturing and product partnerships.** Management plans to partner with select manufacturers who have a proven track record of excellence. These partnerships will reduce the manufacturing risk associated with scaling up product sales and will also allow the Company to expand its brand protection product line.
- **Revenue diversification.** Management believes there are further growth opportunities for OTF and its KolourOptik®-based products are generating strong interest from banknote and brand protection customers. Management has set a strategic goal to increase product revenue in fiscal 2020. Contract services awarded for fiscal 2020 at \$5.0 million are comparable to fiscal 2019, with some opportunities for additional awards and revenue growth in fiscal 2020.

The Company will continue to expand its product line and make further investments in its sales and marketing team and initiatives in order to expand Nanotech's market reach. In the near-term, management expects that Adjusted EBITDA losses will persist as cost increases will outpace revenue growth in fiscal 2020. However, these additional expenditures are expected to support revenue growth beyond 2020.

With a strong balance sheet, including \$10.3 million in cash and short-term investments and no debt, the Company is well positioned to continue to develop and pursue its product-based sales and marketing strategies in 2020.

Recent Events

In September 2019 Mr. Neil McDonnell was appointed to Chair of the Board, replacing Mr. Doug Blakeway, who continues to serve as a director. In October 2019 Mr. Brian Donnelly was promoted to Executive Vice President, Sales and Marketing and Ms. Monika Russell was appointed as Chief Financial Officer.

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, 2019 and 2018

Nanotech Security Corp.
September 30, 2019 and 2018

Table of Contents

Independent Auditors' Report	1
Consolidated Statements of Operations and Comprehensive Loss	4
Consolidated Statements of Financial Position.....	5
Consolidated Statements of Changes in Shareholders' Equity	6
Consolidated Statements of Cash Flows	7
Notes to the Consolidated Financial Statements	8-28



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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. ("the Entity"), which comprise:

- the consolidated statements of financial position as at September 30, 2019 and September 30, 2018
- the consolidated statements of operations and comprehensive loss for the years then ended
- the consolidated statements of changes in shareholders' equity for the years then ended
- the consolidated statements of cash flows for the years then ended
- and notes to the consolidated financial statements, comprising a summary of significant accounting policies

(Hereinafter referred to as the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the consolidated financial position of the Entity as at September 30, 2019 and September 30, 2018, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRS).

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in **the "Auditors' Responsibilities for the Audit of the Financial Statements"** section of our auditors' report.

We are independent of the Entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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

Other Information

Management is responsible for the other information. Other information comprises:

- the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions.



- the information, other than the financial statements and the auditors' report thereon, included in the "Annual report".

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit and remain alert for indications that the other information appears to be materially misstated.

We obtained the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions as at the date of this auditors' report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in the auditors' report.

We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

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

In preparing the financial statements, management is responsible for assessing the Entity's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

Auditors' Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.



As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.

The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit 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.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.
- Provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

KPMG LLP

Chartered Professional Accountants

The engagement partner on the audit resulting in this auditors' report is Konstantin Polyakov.

Vancouver, Canada
December 11, 2019

Nanotech Security Corp.

Consolidated Statements of Operations and Comprehensive Loss
Years ended September 30, 2019 and 2018

(In Canadian dollars)

	2019	2018
		Restated note 4(b)
Revenue (notes 4(b) and 17)	\$ 6,402,702	\$ 8,247,414
Cost of sales (note 18)	1,511,865	1,510,101
	4,890,837	6,737,313
Expenses (note 18)		
Research and development	1,477,668	1,407,430
General and administration	2,307,021	2,532,156
Sales and marketing	2,161,056	2,018,055
Depreciation and amortization	1,481,388	1,485,024
Restructuring costs (note 20)	787,575	-
	8,214,708	7,442,665
Loss from continuing operations before other income	(3,323,871)	(705,352)
Other income		
Foreign exchange gain	(14,982)	(250,023)
Finance income (note 10)	(192,752)	(121,878)
Tenant income (note 4(b))	(214,519)	(237,823)
Steam income (note 4(b))	(66,364)	(172,684)
	(488,617)	(782,408)
Net income (loss) from continuing operations	(2,835,254)	77,056
Net loss from discontinued operations (note 21(c))	-	(123,322)
Net loss	(2,835,254)	(46,266)
Other comprehensive loss:		
Items that may be subsequently reclassified to earnings (loss):		
Unrealized foreign exchange loss on translation of foreign operation (note 21(c))	-	(98,908)
Total comprehensive loss	\$ (2,835,254)	\$ (145,174)
Basic and diluted earnings (loss) per share:		
Continuing operations	\$ (0.04)	\$ 0.00
Discontinued operations	\$ 0.00	\$ 0.00
Net loss	\$ (0.04)	\$ 0.00
Weighted average number of common shares		
Basic and diluted	68,916,001	68,425,673

See accompanying notes to the consolidated financial statements.

Nanotech Security Corp.

Consolidated Statements of Financial Position
As at September 30, 2019 and 2018

(In Canadian dollars)

	2019	2018
Assets		
Current assets:		
Cash and cash equivalents (note 16(c))	\$ 2,752,002	\$ 2,014,764
Short-term investments (note 6)	7,537,262	7,598,857
Accounts receivable (note 13(b))	503,660	1,962,969
Inventory (note 7)	237,264	173,636
Prepaid expenses and other assets	419,753	125,514
	<u>11,449,941</u>	<u>11,875,740</u>
Property, plant and equipment (notes 8 and 16(d))	15,684,845	16,964,857
Goodwill (note 9)	1,388,458	1,388,458
	<u>\$ 28,523,244</u>	<u>\$ 30,229,055</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,232,159	\$ 1,265,282
Deposit	543,368	-
Liabilities directly associated with assets held for sale (note 21(a))	-	16,204
	<u>1,775,527</u>	<u>1,281,486</u>
Non-current liabilities:		
Tenant inducement	16,083	43,653
	<u>1,791,610</u>	<u>1,325,139</u>
Shareholders' equity		
Share capital (note 11(a))	62,355,479	61,892,395
Contributed surplus (note 11(b))	3,130,852	2,930,964
Deficit	(38,754,697)	(35,919,443)
	<u>26,731,634</u>	<u>28,903,916</u>
	<u>\$ 28,523,244</u>	<u>\$ 30,229,055</u>

Related party transactions (note 15)

Commitments (note 19)

See accompanying notes to the consolidated financial statements.

Approved on behalf of the Board of Directors:

"Neil McDonnell"

Neil McDonnell, Director

"Ronan McGrath"

Ronan McGrath, Director

Nanotech Security Corp.

Consolidated Statements of Changes in Shareholders' Equity
Years ended September 30, 2019 and 2018

(In Canadian dollars)

	Number of shares	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at October 1, 2017	68,395,825	\$ 61,426,483	\$ 2,715,137	\$ (35,873,177)	\$ (68,905)	\$ 28,199,538
Net loss	-	-	-	(46,266)	-	(46,266)
Unrealized foreign exchange loss on translation	-	-	-	-	(98,908)	(98,908)
Share-based compensation - options (note 11(b)(i))	-	-	264,627	-	-	264,627
Share-based compensation - RSUs (note 11(b)(ii))	-	-	417,112	-	-	417,112
Foreign exchange reclassified upon disposal of foreign operation (note 21(c))	-	-	-	-	167,813	167,813
RSUs vested (note 11(b)(ii))	375,676	465,912	(465,912)	-	-	-
Balance as at September 30, 2018	68,771,501	\$ 61,892,395	\$ 2,930,964	\$ (35,919,443)	\$ -	\$ 28,903,916
Balance as at October 1, 2018	68,771,501	\$ 61,892,395	\$ 2,930,964	\$ (35,919,443)	\$ -	\$ 28,903,916
Net loss	-	-	-	(2,835,254)	-	(2,835,254)
Share-based compensation - options (note 11(b)(i))	-	-	362,583	-	-	362,583
Share-based compensation - RSUs (notes 11(b)(ii) and 20)	-	-	300,389	-	-	300,389
RSUs vested (note 11(b)(ii))	428,624	463,084	(463,084)	-	-	-
Balance as at September 30, 2019	69,200,125	\$ 62,355,479	\$ 3,130,852	\$ (38,754,697)	\$ -	\$ 26,731,634

See accompanying notes to the consolidated financial statements.

Nanotech Security Corp.

Consolidated Statements of Cash Flows
Years ended September 30, 2019 and 2018

(In Canadian dollars)

	2019	2018
Cash flows provided by (used in):		
Operating activities:		
Net income (loss) from continuing operations	\$ (2,835,254)	\$ 77,056
Items not involving cash:		
Depreciation and amortization (note 18)	1,566,122	1,611,891
Share-based compensation (notes 18 and 20)	662,972	681,739
Unrealized foreign exchange gain	(2,448)	-
Interest income (note 10)	(201,332)	(132,774)
Other	(27,223)	6,312
Non-cash working capital changes (note 16(a))	1,578,505	(889,380)
Interest received	200,927	98,892
	942,269	1,453,736
Net cash provided by (used in) discontinued operations (note 21(b))	(16,204)	76,694
Cash provided by operating activities	926,065	1,530,430
Investing activities:		
Purchase of property and equipment (notes 8 and 16(d))	(249,468)	(2,701,820)
Disposal of short-term investments	203,314	-
Net acquisition of short-term investments	(141,660)	(7,598,857)
Cash used in investing activities	(187,814)	(10,300,677)
Effect of foreign exchange on cash and cash equivalents	(1,013)	(98,908)
Increase (decrease) in cash and cash equivalents	737,238	(8,869,155)
Cash and cash equivalents, beginning of year	2,014,764	10,883,919
Cash and cash equivalents, end of year	\$ 2,752,002	\$ 2,014,764

See supplementary cash flow information (note 16)
See accompanying notes to the consolidated financial statements.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

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 researches, creates, and produces nano-optic structures and colour-shifting materials used in authentication and brand enhancement applications across a wide range of markets including banknotes, tax stamps, secure government documents, and commercial branding.

2. Basis of preparation

(a) *Statement of compliance*

These consolidated financial statements are prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”). These consolidated financial statements were approved and authorized for issue by the Company’s Board of Directors on December 11, 2019.

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 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, 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.

Management evaluates goodwill for impairment annually as at September 30th. Impairment tests involve considerable use of judgment and require management to make estimates and assumptions. The fair values of CGUs are derived from certain valuation models, which consider various factors such as discount rates, future earnings, and revenue growth rates. While management uses its 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, and determination of CGUs and segments.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

2. Basis of preparation (continued)

(d) *Basis of consolidation*

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Tactical Technologies Inc. ("Tactical") up to September 28, 2018, the date of Tactical's dissolution (note 21). All intercompany balances and transactions are eliminated on consolidation. The financial statements of subsidiaries are included in 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. Tactical's functional currency was 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 profit or loss.

(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 profit or loss upon disposition of a foreign operation (note 21(c)).

3. Significant accounting policies

(a) *Revenue recognition*

The Company recognizes revenue when control of goods or services has been transferred to the customer. Revenue is measured at the fair value of consideration to which the Company expects to be entitled to, including variable consideration, if any, to the extent that it is highly probable that a significant reversal will not occur.

Revenue from contract services is recognized over time as those services are provided. Invoices for contract services are issued on a monthly basis and are usually payable within 30 days. Revenue from the sale of products is recognized when customers obtain control, which occurs when products are shipped. Invoices are generated at that point in time and are usually payable within 30 days. The Company does not offer any discounts or returns.

(b) *Earnings (loss) per common share*

Basic net earnings (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 restricted share units ("RSU"), 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 recording a loss, basic and diluted figures are the same, as the exercise of all stock options and RSUs would be anti-dilutive.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

3. Significant accounting policies (continued)

(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 expenditures, and borrowing costs on qualifying assets. Other development costs are expensed in the period incurred. During the years ended September 30, 2019 and 2018, 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 the Company will comply with the relevant conditions and that 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 profit or loss is reversed immediately in the period that the assistance becomes repayable.

Refundable 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. Non-refundable investment tax credits are recorded using the flow-through method, whereby the credits are accounted for as a reduction of tax expense and recognized as a tax asset to the extent that it is probable that taxable profits will be available against which they can be utilized.

(e) *Financial instruments*

The Company adopted IFRS 9 – *Financial instruments* on October 1, 2018. The accounting policies listed below reflect IFRS 9. See Note 4(a) for a discussion of comparisons to IAS 39 – *Financial Instruments Recognition and Measurement*, which was in effect for the comparative period.

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provision of a financial instrument. Financial assets are derecognized when the contractual rights to receive cash flows from the financial asset expire. Financial liabilities are derecognized when obligations under the contract expire, are discharged, or canceled.

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 an intention to settle on a net basis or realize the asset and settle the liability simultaneously.

(i) *Financial assets*

The following accounting policies apply to the classification of financial assets:

- **Amortized Cost** – the asset is held within a business model whose objective is to collect contractual cash flows, and the contractual terms give rise to cash flows that are solely payments of principal and interest.
- **Fair Value Through Other Comprehensive Income** – cash flows arising from the asset are solely payments of principal and interest, and the asset is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
- **Fair Value Through Profit and Loss** – all financial assets not classified as measured at Amortized Cost or Fair Value Through Other Comprehensive Income are measured at Fair Value Through Profit and Loss. On initial recognition, the Company may irrevocably designate a financial asset as

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

3. Significant accounting policies (continued)

(e) *Financial instruments (continued)*

(i) Financial assets (continued)

Fair Value Through Profit and Loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise under Amortized Cost or Fair Value Through Other Comprehensive Income.

A financial asset (unless it is a trade receivable without a significant financing component that is initially measured at the transaction price) is initially measured at fair value plus transaction costs that are directly attributable to its acquisition (except items at Fair Value Through Profit and Loss, which do not include transaction costs).

The following accounting policies apply to the subsequent measurement of financial assets:

- Amortized Cost – the asset is subsequently measured at amortized cost using the effective interest method. Interest income, foreign exchange gains or losses and impairment are recognized in profit or loss. Any gain or loss on derecognition is recognized in profit or loss.
- Fair Value Through Other Comprehensive Income – the asset is subsequently measured at fair value. Interest income calculated using the effective interest rate method, foreign exchange gains or losses and impairment are recognized in profit or loss. Other net gains and losses are recognized in other comprehensive income. On derecognition, gains and losses accumulated in other comprehensive income are reclassified to profit or loss.
- Fair Value Through Profit and Loss – the asset is subsequently measured at fair value. Net gains and losses, including any interest income, are recognized in profit or loss.

The Company's financial assets, which include cash and cash equivalents, short-term investments, and accounts receivable, are classified as amortized cost.

(ii) Financial liabilities

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

Other financial liabilities include trade and other payables and non-trade payables. 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 as other financial liabilities.

(iii) 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 profit or loss. Embedded derivatives are recorded at fair value through profit or loss. During the years ended September 30, 2019 and 2018, the Company did not have any derivative instruments or embedded derivatives.

(f) *Cash and cash equivalents*

Cash and cash equivalents consist of cash balances with banks, investments with original maturities of three months or less, and investments that are both readily convertible to cash and subject to insignificant changes in market value.

(g) *Short-term investments*

Short-term investments consist of short-term interest-bearing term deposits which are highly liquid with maturity dates greater than three months but less than one year at the time of purchase.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

3. Significant accounting policies (continued)

(h) *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.

(i) *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	straight line over the lesser of lease term or estimated useful life

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

(j) *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, 2019 and 2018, 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.

(k) *Impairment*

(i) Financial assets

The Company recognizes loss allowances for expected credit losses on financial assets measured at amortized cost. Loss allowances for trade receivables are measured at an amount equal to lifetime expected credit losses. Lifetime expected credit losses are the result of all possible default events over the expected life of a financial instrument. Expected credit losses are a probability-weighted estimate of credit losses and credit losses are measured as the present value of cash shortfalls from a financial asset. The Company determines whether the credit risk of a financial asset has increased significantly since initial recognition and when estimating lifetime expected credit losses, by considering reasonably available quantitative and qualitative information based on the Company's credit risk experience, forward looking information, and other reasonable estimates.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

3. Significant accounting policies (continued)

(k) *Impairment (continued)*

(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 a CGU or groups of CGUs based on the level at which it is monitored for internal reporting purposes. An impairment loss is recognized in profit or loss 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 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 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.

(l) *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.

(m) *Share-based compensation – stock options*

The Company issues stock options to directors, consultants, and employees pursuant to its stock option plan. 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 award 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 amount of compensation expense recognized in profit or loss. When stock options are exercised, any consideration paid by directors, consultants, and employees, as well as the related share-based compensation, is credited to share capital.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

3. Significant accounting policies (continued)

(n) *Share-based compensation - restricted share units*

During the year ended September 30, 2019, the Company issued RSUs pursuant to its 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 TSX Venture Exchange 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.

(o) *Income taxes*

Income tax expense is comprised of current and deferred tax. Current and deferred tax are recognized into profit or loss 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 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 offset 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.

(p) *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 substantially transfers 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 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 profit or loss as they are incurred on a straight-line basis over the lease term.

(q) *Segment reporting*

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

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

3. Significant accounting policies (continued)

(r) *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 losses on remeasurement are recognized in the statement of income. 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 statements 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. 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 represents 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 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. Change in accounting policy

(a) *IFRS 9 – Financial Instruments*

In July 2014, the IASB issued IFRS 9 – *Financial Instruments*, which replaces 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 and a single, forward-looking 'expected credit loss' impairment model.

The Company adopted IFRS 9 on October 1, 2018. The adoption of IFRS 9 did not have an impact on the Company's consolidated financial statements and related disclosures. With respect to classification and measurement, the Company has applied the exemption not to restate comparative information for prior periods. The determination of the business model within which a financial asset is held has been made on the basis of facts and circumstances that existed at the date of initial application.

The following table explains the original measurement categories under IAS 39 and the new measurement categories under IFRS 9 for each class of financial assets as at October 1, 2018.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

4. Change in accounting policy (continued)

(a) IFRS 9 – Financial Instruments (continued)

Financial assets	IAS 39	IFRS 9
Cash and cash equivalents	Loans & receivables	Amortized cost
Short-term investments	Loans & receivables	Amortized cost
Trade and other receivables	Loans & receivables	Amortized cost

There was no change in classification of financial liabilities as a result of the adoption of IFRS 9. There are no differences in the carrying amounts of financial assets and financial liabilities resulting from the adoption of IFRS 9.

(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.

The Company adopted IFRS 15 on October 1, 2018. Its adoption did not have a material impact on the Company's consolidated financial statements and related disclosures, except for the reclassification of tenant and steam income, as described below. The Company has applied IFRS 15 in accordance with the full retrospective transitional approach without applying any practical expedients.

IFRS 15 requires entities to recognize revenue when 'control' of goods or services transfers to the customer whereas the previous standard, IAS 18, required entities to recognize revenue when the 'risks and rewards' of goods or services transfer to the customer. The Company concluded there is no change in the timing of revenue recognition under IFRS 15 compared to the previous standard as the point of transfer of risks and rewards of goods and services and transfer of control occur at the same time. However, the Company identified that tenant and steam income do not arise from the entity's ordinary activities, and therefore does not meet the definition of revenue under IFRS 15. As a result, tenant and steam income have been reclassified to other income retrospectively.

For the year ended September 30, 2018, revenue was previously reported as \$9,199,710 and restated as \$8,247,414, due to a reclass of \$257,548 to tenant income and \$694,748 to steam income. Cost of sales was previously reported as \$2,051,890 and restated as \$1,510,101, due to a reclass of \$19,725 to tenant income and \$522,064 to steam income. There was no impact on net loss and loss per share.

(c) Other

The Company has adopted narrow scope amendments/interpretations to IFRIC 22 – *Foreign Currency Transactions and Advance Consideration* and IFRS 2 – *Share Based Payments*, which did not have an impact on the Company's consolidated financial statements.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

5. New standards and interpretations not yet adopted

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 will adopt the standard on October 1, 2019, using the modified retrospective approach. The modified retrospective approach applies the requirements of the standard retrospectively with the cumulative effects of initial application recorded in opening accumulated deficit as at October 1, 2019, and no restatement of the comparative period.

Based on the information available at September 30, 2019, as a result of the initial application of IFRS 16 as at October 1, 2019, the Company anticipates recognizing the following on its statement of financial position: right-of-use assets of approximately \$800,000 (including approximately \$16,000 tenant inducement), and a lease liability of approximately \$816,000. The right-of-use assets will be depreciated on a straight-line basis over the remaining lease term. The lease liability will be carried at amortized cost with a finance charge recorded from the amortization of the lease liability discount. The depreciation expense of the right-of-use assets and the finance charge of the lease liability will partially replace the lease-related expenses recorded in general and administration expense.

6. Short-term investments

Short-term investments of \$7,537,262 (2018 - \$7,598,857) consist of cashable term deposits held with a Canadian chartered bank. The term deposits have maturity dates between December 18, 2019 and December 23, 2019. Interest rates range between 1.94% and 1.97%.

7. Inventory

	2019	2018
Raw materials	\$ 134,435	\$ 160,550
Work in progress	100,087	13,086
Finished goods	2,742	-
	<u>\$ 237,264</u>	<u>\$ 173,636</u>

There were inventory write-downs of \$47,513 during the year ended September 30, 2019 (2018 - \$nil).

For the year ended September 30, 2019, the Company recognized inventories of \$351,734 (2018 - \$290,864) as expensed through cost of sales.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

8. Property, plant and equipment

	Land	Building and leasehold improvement	Manufacturing equipment	Laboratory, software, and office equipment	Total
Cost					
Balance as at October 1, 2017	\$ 141,700	\$ 3,871,578	\$ 15,922,956	\$ 245,055	\$ 20,181,289
Additions	-	487,549	2,083,180	149,021	2,719,750
Balance as at September 30, 2018	141,700	4,359,127	18,006,136	394,076	22,901,039
Additions	-	194,030	21,761	77,596	293,387
Balance as at September 30, 2019	\$ 141,700	\$ 4,553,157	\$ 18,027,897	\$ 471,672	\$ 23,194,426
Accumulated depreciation					
Balance as at October 1, 2017	\$ -	\$ 493,462	\$ 3,669,053	\$ 161,776	\$ 4,324,291
Depreciation expense	-	203,203	1,329,549	79,139	1,611,891
Balance as at September 30, 2018	-	696,665	4,998,602	240,915	5,936,182
Depreciation expense	-	176,239	1,301,842	95,318	1,573,399
Balance as at September 30, 2019	\$ -	\$ 872,904	\$ 6,300,444	\$ 336,233	\$ 7,509,581
Net book value					
September 30, 2019	\$ 141,700	\$ 3,680,253	\$ 11,727,453	\$ 135,439	\$ 15,684,845
September 30, 2018	\$ 141,700	\$ 3,662,462	\$ 13,007,534	\$ 153,161	\$ 16,964,857

Additions, disposals, and depreciation for the years ended September 30, 2019 and 2018 are for continuing operations.

Included in amortization for the year ended September 30, 2018 is an impairment charge of \$29,872 recorded against certain assets in order to bring them down to their recoverable values.

9. Goodwill

The Company performs a goodwill impairment test 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 recoverable amount of the CGU is measured as its value in use, estimated using discounted cash flows. 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 ten year forecast period, with a terminal value extrapolated into the future over the estimated useful life of the CGU.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

9. Goodwill (continued)

The key assumptions used in performing impairment tests are as follows:

- Discount rate:

Management applied a discount rate of 12% (2018 – 12%) in calculating the recoverable amount. This 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.

- Terminal growth rate:

Management has assumed a terminal growth rate of nil (2018 – nil) beyond the ten year term, which management deems appropriate given the early stages of the Company's commercialization.

- Forecast period:

Management used a ten year forecast period as this was deemed more appropriate for a company commercializing a new technology and entering new markets.

Management performs sensitivity analysis on the key assumptions. Sensitivity analysis indicates reasonable changes to key assumptions will not result in an impairment loss.

10. Finance (income) expense

	2019	2018
Interest income from cash and cash equivalents and short-term investments	\$ (201,332)	\$ (132,774)
Other interest expenses	8,580	10,896
	<u>\$ (192,752)</u>	<u>\$ (121,878)</u>

11. 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, 2017	68,395,825	\$ 61,426,483
RSUs vested	375,676	465,912
Balance as at September 30, 2018	68,771,501	\$ 61,892,395
RSUs vested	428,624	463,084
Balance as at September 30, 2019	<u>69,200,125</u>	<u>\$ 62,355,479</u>

There are no preferred shares issued and outstanding.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

11. Share capital (continued)

(b) Share-based payment plans

(i) Stock option plan

Under the Company's stock option plan, the maximum number of shares that may be reserved for grant of options at any point in time is 10% of the outstanding shares, less any shares reserved for issuance under the RSU plan. The following stock options were outstanding as at September 30, 2019:

	Number of options	Weighted average exercise price
Balance as at October 1, 2017	2,040,000	\$ 1.35
Granted	567,500	1.35
Balance as at September 30, 2018	2,607,500	\$ 1.35
Granted	1,677,500	0.61
Expired	(750,000)	0.82
Balance as at September 30, 2019	3,535,000	\$ 0.95

The following table summarizes information pertaining to the Company's stock options outstanding as at September 30, 2019:

Range of exercise prices	Options outstanding			Options exercisable	
	Number of options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
\$0.00 - \$1.00	1,677,500	3.99	\$ 0.61	821,250	\$ 0.61
\$1.01 - \$1.25	1,126,500	1.44	1.14	1,076,500	1.13
\$1.26 - \$1.65	731,000	2.51	1.42	731,000	1.42
	3,535,000	2.87	\$ 0.95	2,628,750	\$ 1.05

The Company calculates the fair value of options at the grant date using the Black-Scholes option-pricing model. The table below outlines the weighted average assumptions used to estimate the fair value of options granted during the years ended September 30, 2019 and 2018:

	2019	2018
Risk free interest rate	2.0%	1.9%
Expected life	4.7 years	4.6 years
Expected volatility	45%	43%
Expected dividends	Nil	Nil
Average fair value	\$ 0.23	\$ 0.52

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:

	2019	2018
Total compensation - stock options	\$ 362,583	\$ 264,627

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

11. Share capital (continued)

(b) Share-based payment plans (continued)

(ii) Restricted share unit plan

Under the Company's RSU plan, the maximum number of shares that may be reserved for issuance is fixed at 2,700,000. As at September 30, 2019, 905,927 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.

RSUs outstanding as at September 30, 2019:

	Number of RSUs
Balance as at October 1, 2017	529,560
Forfeited	(22,060)
Granted	238,782
Vested	(375,676)
Balance as at September 30, 2018	370,606
Forfeited	(15,120)
Granted	298,640
Vested	(428,624)
Balance as at September 30, 2019	225,502

During the year ended September 30, 2018 the Company granted 238,782 RSUs. The weighted average fair value was \$1.40 per share. 25% of these RSUs vested on September 1, 2018, 35% vested on September 1, 2019, and the remaining 40% will vest on September 1, 2020.

During the year ended September 30, 2019 the Company granted 298,640 RSUs. The weighted average fair value was \$0.56 per share. 25% of these RSUs vested on September 1, 2019, 35% will vest on September 1, 2020, and the remaining 40% will vest on September 1, 2021.

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:

	2019	2018
Total compensation - RSUs	\$ 208,189	\$ 417,112

12. 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 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 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.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

13. Financial instruments and risk exposures

(a) Fair value measurement

The Company's financial assets include cash and cash equivalents, short-term investments, and accounts receivable. The Company's financial liabilities include accounts payable and accrued liabilities.

Cash and cash equivalents, short-term investments, and accounts receivable are classified as financial assets at amortized cost. Financial assets at amortized cost are initially recognized at fair value and subsequently carried at amortized cost less any impairment. Accounts payable and accrued liabilities 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 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, 2019 and September 30, 2018, the balance of the allowance account for credit losses was \$nil.

Pursuant to their respective terms, accounts receivable was aged as at September 30, 2019 and 2018:

	2019	2018
0 – 30 days	\$ 380,092	\$ 1,123,809
31 – 60 days	48,918	553,536
61 – 90 days	7,735	-
Greater than 90 days	22,584	282,432
Total accounts receivable*	\$ 459,329	\$ 1,959,777

*Certain balances included within accounts receivable such as GST, QST and PST receivables are not financial instruments and as such, are excluded from the note disclosure.

There is a possibility of increased customer credit risk due to the ongoing global recessionary trends. As at September 30, 2019, the Company's accounts receivable are made up of approximately 46% (2018 - 46%) government trade receivables and the balance of the outstanding accounts receivable are spread over several other customers.

During the year ended September 30, 2019, the Company had two customers who represented greater than 10% of total revenues. They represented approximately 80% and 14% respectively of total revenues. (2018 – one customer represented approximately 81% of total revenues).

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

13. Financial instruments and risk exposures (continued)

(b) *Credit risk (continued)*

The Company may also have credit risk relating to cash and cash equivalents and short-term investments, which it manages by dealing with large banks and investing in highly liquid investments. The Company's objective is to minimize its 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, 2019 totaled \$2,752,002 (2018 - \$2,014,764), short-term investments of \$7,537,262 (2018 - \$7,598,857) and accounts receivables of \$459,329 (2018 - \$1,959,777), 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, 2019, the Company had cash and cash equivalents of \$2,752,002 (2018 - \$2,014,764), short-term investments of \$7,537,262 (2018 - \$7,598,857), and accounts receivable of \$459,329 (2018 - \$1,959,777) for a total of \$10,748,593 (2018 - \$11,573,398). 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 of 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 relates primarily to cash equivalents and short-term investments. The Company does not enter into any interest rate swaps to mitigate interest rate risk.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

14. 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 (loss) from continuing operations before income taxes. The principal factors causing these differences are shown below:

	2019	2018
Income (loss) from continuing operations before income taxes	\$ (2,835,254)	\$ 77,056
Statutory tax rate	26.86%	26.73%
Expected tax expense (recovery)	(761,549)	20,597
Effective tax rate change and other	(9,935)	(381,819)
Permanent differences	182,719	171,849
Non-refundable investment tax credits	(279,553)	(139,148)
Changes in deferred tax assets arising from discontinued operations	-	(469,263)
Change in unrecognized deferred tax assets	868,318	797,784
Income tax recovery	\$ -	\$ -

(b) *Recognized deferred tax assets and liabilities*

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

	2019	2018
Deferred tax assets		
Non-capital losses carried forward	\$ 2,746,799	\$ 2,790,683
Deferred tax liabilities		
Property, plant, and equipment	(2,746,799)	(2,790,683)
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:

	2019	2018
Non-capital loss carry forwards	\$ 9,904,837	\$ 8,520,026
Capital loss carry forwards	5,732,539	5,732,539
Non-refundable investment tax credits	1,053,322	668,251
Other temporary differences	7,722,972	7,345,635
Unrecognized deductible temporary differences	\$ 24,413,670	\$ 22,266,451

(d) *Loss carry forwards*

As at September 30, 2019, the Company has tax loss carry forwards of approximately \$20,147,513 (2018 - \$18,948,528). The Company's tax loss carry forwards will expire, if not utilized, commencing in 2030. The Company recognizes the benefit of tax losses only to the extent of anticipated future taxable income. As at September 30, 2019, the Company has capital losses of approximately \$5,732,539 (2018 - \$5,732,539) that may be carried forward indefinitely to apply against future years' capital gains.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

14. Income taxes (continued)

(e) R&D and tax credit attributes

As at September 30, 2019, the Company had unclaimed tax deductions of scientific research and experimental development expenditures of \$3,548,000 (2018 - \$2,322,000) that are available to reduce taxable income in future years and may be carried forward indefinitely. As at September 30, 2019, the Company has federal investment tax credits of \$836,000 (2018 - \$555,000) and provincial investment tax credits of \$217,000 (2018 - \$114,000) that may be carried forward to apply against future years' income tax payable. These investment tax credits begin to expire in 2031 and 2022 respectively.

15. Related party transactions

(a) The remuneration of key management personnel

	2019	2018
Salaries, accrued bonuses, employee benefits and director fees	\$ 712,298	\$ 1,330,306
Share-based payments	255,476	493,881
Restructuring costs (note 20)	787,575	-
	\$ 1,755,349	\$ 1,824,187

(b) As at September 30, 2019, amounts owing to a company controlled by a director of the Company included in accounts payable and accrued liabilities were \$90,938 (2018 - \$191,433). These payables represent amounts owing under the terms of an executive services consulting agreement, including payments owing upon early termination of this agreement (note 20).

(c) Legal and professional fees, taxes and disbursements totaling \$42,485 for the year ended September 30, 2019 (2018 - \$81,776) were incurred with a law firm of which a director of the Company is a partner. As at September 30, 2019, amounts owing to this company included in accounts payable and accrued liabilities were \$nil (2018 - \$50,780). During the year ended September 30, 2019, the Company retained new legal counsel and moved its registered and records office.

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.

16. Supplementary cash flow information

(a) Change in non-cash working capital

	2019	2018
Accounts receivable	\$ 1,460,592	\$ (588,527)
Inventory	(56,352)	(21,928)
Prepaid expenses and other assets	(295,475)	62,360
Accounts payable and accrued liabilities (note 16(d))	(73,628)	(184,114)
Deposit	543,368	(157,171)
	\$ 1,578,505	\$ (889,380)

(b) Income taxes

The Company did not pay any income taxes during the years ended September 30, 2019 and 2018.

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

16. Supplementary cash flow information (continued)

(c) Cash and cash equivalents

Cash and cash equivalents consist of cash balances with banks, investments with original maturities of three months or less, and investments that are both readily convertible to cash and subject to insignificant changes in market value

	2019	2018
Cash	\$ 752,911	\$ 292,688
Cash equivalents	1,999,091	1,722,076
	<u>\$ 2,752,002</u>	<u>\$ 2,014,764</u>

(d) Supplemental disclosure of non-cash financing activities

As at September 30, 2019, property, plant and equipment included in accounts payable was \$61,849 (2018 - \$17,930).

17. Revenue and segmented information

The Company's continuing operations currently consist of one operating segment. Within this operating segment revenue is disaggregated by type as follows:

	2019	2018
Development contracts	\$ 5,113,764	\$ 7,234,895
Products and services	1,288,938	1,012,519
	<u>\$ 6,402,702</u>	<u>\$ 8,247,414</u>

For the year ended September 30, 2019, sales within Canada were \$354,518 (2018 - \$160,881) and sales outside Canada were \$6,048,184 (2018 - \$8,086,533).

During the year ended September 30, 2019, the Company had two customers who represented greater than 10% of total revenues. They represented approximately 80% and 14% respectively of total revenues (2018 – one customer represented approximately 81% of total revenues).

18. Nature of expenses

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

	2019	2018
Salaries and benefits	\$ 3,302,635	\$ 3,464,740
Share-based compensation	570,772	681,739
Depreciation and amortization	1,566,122	1,613,491
Travel and entertainment	323,996	332,586
Professional fees and insurance	974,924	858,417
Public company costs	387,533	573,305
Rent and utilities	725,709	645,560
Maintenance and office expenses	379,193	234,917
Materials consumed	708,114	548,011
Restructuring costs (note 20)	787,575	-
	<u>\$ 9,726,573</u>	<u>\$ 8,952,766</u>

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

19. Commitments

- (a) As at September 30, 2019, the Company is committed to operating leases, in respect of office space, and to contracted equipment maintenance for the following amounts:

2020	\$	365,523
2021		246,102
2022		240,183
2023		145,924
	\$	997,732

- (b) Certain nano-optic products are subject to a 3% sales royalty in favour of Simon Fraser University where certain elements of the nano-optic technology originated. Royalties were \$828 during the year ended September 30, 2019 (2018 - \$nil).

Subsequent to September 30, 2019, the Company renewed office leases for a 5-year term ending in 2025.

20. Restructuring costs

On December 21, 2018, the Board of Directors implemented an executive transition plan, under which Mr. Doug Blakeway, the former CEO, transitioned his responsibilities to Mr. Troy Bullock. Under the terms of this transition plan, Mr. Blakeway's executive services consulting agreement was terminated, triggering the following early termination benefits as laid out in the agreement: two years base salary, a pro-rated performance bonus, and vesting of all outstanding share-based awards. The Company incurred restructuring costs of \$787,575 as at September 30, 2019 (September 30, 2018 - \$nil), of which \$92,200 represented share-based compensation related to the accelerated vesting of Mr. Blakeway's RSUs.

In January 2019, termination benefits were paid and 187,500 shares were issued to Mr. Blakeway upon vesting of his RSUs. Restructuring costs of \$84,375 remain accrued as at September 30, 2019 (September 30, 2018 - \$nil).

21. Discontinued operations

On September 21, 2017, the Board of Directors made the determination that the Company would pursue the possible sale of the assets of its subsidiary, Tactical, to a third party. At September 30, 2017, Tactical was classified as a separate disposal group held for sale and as a discontinued operation.

On June 29, 2018, the assets used in connection with Tactical's surveillance equipment and van conversion business were sold to an employee of Tactical for a nominal amount and on September 28, 2018, Tactical was dissolved and struck from the corporate register.

- (a) *Assets and liabilities of Tactical classified as held for sale*

	2019	2018
Accounts payable and accrued liabilities	\$ -	\$ 16,204
Liabilities directly associated with assets held for sale	\$ -	\$ 16,204

- (b) *Net cash flows provided by (used in) discontinued operations*

	2019	2018
Net loss from discontinued operations	\$ -	\$ (123,322)
Foreign exchange reclassified upon disposal of foreign operation	-	167,813
Non-cash working capital changes	(16,204)	32,203
	\$ (16,204)	\$ 76,694

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
(Expressed in Canadian dollars)

Years ended September 30, 2019 and 2018

21. Discontinued operations (continued)

(c) *Net loss from discontinued operations, net of income taxes*

	2019	2018
Revenue	\$ -	\$ 827,256
Cost of sales	-	454,573
Gross Profit	-	372,683
Expenses		
General and administration	-	311,217
Sales and marketing	-	14,994
	-	326,211
Income before other expenses	-	46,472
Other (income) expense		
Finance expense	-	3,419
Gain on disposal of foreign operation (note 21(d))	-	(1,438)
Foreign exchange reclassified on disposal of foreign operation	-	167,813
	-	169,794
Net loss from discontinued operations	-	(123,322)
Other comprehensive loss		
Unrealized foreign exchange loss on translation of foreign operation	-	(98,908)
Net comprehensive loss from discontinued operations	\$ -	\$ (222,230)

(d) *The effect of the disposal of Tactical on the financial position of the Company on June 29, 2018 is as follows:*

Cash proceeds	\$ 1
Cash	(66,385)
Accounts receivable	(22,933)
Inventory	(51,749)
Prepaid expenses	(894)
Accounts payable and accrued liabilities	143,400
Net assets disposed	1,439
Gain on disposal of foreign operations	\$ (1,438)