Annual Report

September 30, 2016

Amended – To format headings on the notes as at December 21, 2016

NANOTECH
SECURITY CORP.

For purposes of this management discussion and analysis ("MD&A"), "Nanotech", the "Company", "we", or "us" refers to Nanotech Security Corp. and its subsidiaries. This year and 2016 mean the fiscal year ended September 30, 2016. Last year and 2015 mean the fiscal year ended September 30, 2015, and 2014 means the fiscal year ended September 30, 2014. This quarter means the three months ended September 30, 2016.

ADVISORY

This MD&A, dated as of December 14, 2016, 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, 2016 (the "Consolidated Financial Statements"). The results reported herein have been prepared in accordance with International Financial Reporting Standards ("IFRS") and are presented in Canadian dollars. All quarterly information disclosed in the MD&A is based on unaudited figures.

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

FORWARD-LOOKING STATEMENTS

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

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

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

GENERAL OVERVIEW

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

The Company operates its business through two business segments – Optics and Tactical. The Company's reportable segments are strategic business units that offer different products and services. They are managed separately as each business is in a different stage in its life cycle and they require different sales and marketing strategies.

Optics
The Optics division (previously named Security Features) designs, manufactures and markets nano-optic optical variable devices ("OVDs") and optical thin film ("OTF") products. These products have brand authentication and enhancement applications across a wide range of markets including banknotes, secure government documents, commercial branding, and the pharmaceutical industry. Nanotech is initially focusing its efforts on the banknote market due to its high margins and the Company has established a very strong customer base.

The Company's nano-optic technology employs arrays of billions of nano-indentations that are impressed or embossed onto a substrate material such as polymer, paper, metal, or fabric. By using sophisticated algorithms to direct an electron beam, the Company creates arrays of unique light signatures (visual images). These nano-indentation structures create images with colour shifting effects that provide visual features such as 3D, high-definition, and motion-impression, and can also display distinct colours including skin tones, white, and black; some of which effects are not possible using current holographic technology.

The OTF technology 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.

Tactical
The Company's legacy Tactical division (previously named Surveillance) designs and sells a wide range of sophisticated surveillance and officer protection equipment and conducts surveillance training for the law enforcement and defense industries in the United States and Canada. These products include outfitting surveillance vans for covert operations and services include teaching accredited classes in electronic surveillance. The Tactical division conducts research, production, and training at its facility in Holmes, PA, USA.

The Tactical division customizes surveillance vans for government agencies and has successfully developed surveillance products, including most recently the P-25 digital transmission system allowing federal, state and local law enforcement agencies to communicate with each other over a single frequency using both digital and analog frequencies, and the release of the Echo 8i that converts analog audio signals to digital, enabling secure smart phone wireless connectivity.

RESULTS OF OPERATIONS

Selected financial information for the years ended September 30, 2016, 2015, and 2014:

Selected Financial Information

Results of Operations	2016	2015	2014
Revenue	$ 5,126,109	$ 5,152,762	$ 2,229,494
Cost of sales	2,303,987	2,921,687	1,477,432
Gross profit	2,822,122	2,231,075	752,062
Expenses			
Research and development	5,350,280	4,158,108	2,092,012
General and administration	2,655,457	2,455,131	2,445,432
Sales and marketing	2,369,258	1,884,113	664,003
	10,374,995	8,497,352	5,201,447
Loss before other expenses (income) and income taxes	(7,552,873)	(6,266,277)	(4,449,385)
Other expenses (income)	439,729	(1,595,444)	(173,828)
Loss before income taxes	(7,992,602)	(4,670,833)	(4,275,557)
Deferred income tax recovery	162,797	-	3,892,450
Net loss	$ (7,829,805)	$ (4,670,833)	$ (383,107)
Loss per share – basic and diluted	$ (0.15)	$ (0.09)	$ (0.01)

Financial Position as at September 30	**2016**	**2015**	**2014**
Total assets	$24,511,586	$27,783,859	$29,749,852
Total long-term financial liabilities	3,693,935	3,126,363	6,100,000
Shareholders' equity	16,422,083	22,924,873	22,027,680

Revenue
Consolidated revenues for the year ended September 30, 2016 decreased by $26,653 or 1% to $5,126,109 which is comparable to $5,152,762 in the same period last year. Optics revenue was down $209,426 compared to last year primarily due to OTF production delays with an Asian issuing authority. This revenue reduction was partially offset by increased customer development work performed during the year.

During the year, internal OTF production was negatively impacted as the Company focused its development team on integrating its colour-shifting OTF technology into an Austrian third-party manufacturer, Hueck Folien GmbH ("Hueck"), to enable Nanotech to deliver significant volume to a large Asian issuing authority. The Company has signed a supply and collaboration agreement with Hueck that licenses Hueck to manufacture one meter wide colour-shifting OTF exclusively for Nanotech.

This integration has continued to consume internal resources in bringing the new manufacturing facility online. In May 2016, the Company completed the supplier acceptance process with the Asian issuing authority and had commenced production and delivery of colour-shifting OTF through its manufacturing partner Hueck. To date, the Company continues to work with its Asian customer to finalize the product specifications and integrate the OTF into the Asian customer's own production facility. Initial deliveries continue to be scrutinized and reviewed by the customer as they work to ensure they are seamlessly integrated into their production facility. Continued progress has been made over the past few months and all parties are optimistic that volume production will commence in the near term. Although there have been unforeseen delays, management is still confident that once production resumes, the Company will be well positioned to deliver throughout the life of this banknote.

Tactical's revenues were up $182,773 compared to last year which was primarily due to an increase in the foreign exchange rate in the current year. During the year, Tactical improved its revenue mix to include an increase in higher margin surveillance vans, which was offset by a reduction in lower margin product sales.

Gross Margin

Gross margin dollars for the year ended September 30, 2016 increased by $591,047 or 27% to $2,822,122 compared to $2,231,075 last year. Overall, gross margin percentage reached 55% for the year ended September 30, 2016, an improvement from 43% in the same period last year. The gross margins continue to reflect strong margins on the Optic division's development contracts.

Research and Development

Research and development expenditures increased by $1,192,172 or 29% to $5,350,280 compared to $4,158,108 last year. This is primarily a result of an increase in depreciation of $791,655 reflecting a 2015 revision of the Company's depreciation policy. Research and development activity for the current year continued to focus on bringing the new Hueck production facility online as well as developing new security features targeted for the banknote market.

General and Administration

General and administration expenditures for the year ended September 30, 2016 were $2,655,457, an increase of $200,326 compared to $2,455,131 last year which reflected higher office rent, property tax, salaries, and overheads.

Sales and Marketing

Sales and marketing expenditures for the year ended September 30, 2016 were $2,369,258, an increase of $485,145 compared to $1,884,113 last year due to increased sales and marketing activity relating to the Optics business unit including increased salaries, stock-based compensation, and international travel.

Net Loss

The net loss for the year was $7,829,805 compared to $4,670,833 during the same period last year. The increase largely reflects higher depreciation and amortization expense of $746,970, increased financing costs, sales and marketing costs, foreign exchange loss in the current year, and a gain on the revaluation and settlement of contingent shares of $1,450,000 during the previous year.

SEGMENT RESULTS

The Company analyzes financial performance by segments, which regroup related activities within the Company. The Company's two reportable operating segments are Optics and Tactical. Inter-segment transactions have been eliminated from the segmented financial information discussed below.

Optics

The Optics division designs, manufactures and markets nano-optic OVDs and OTF products. These products have brand protection and enhancement applications across a wide range of markets including banknotes, secure government documents, commercial branding, and the pharmaceutical industry.

	2016	2015
Revenue	$ 2,888,896	$ 3,098,322
Loss before income taxes	$(7,821,707)	$(4,536,593)

Revenues from Optics for 2016 decreased to $2,888,896 from $3,098,322 for 2015. The decreased revenue was primarily due to decreased delivery of OTF as the Company focused on bringing Hueck online.

The loss before income taxes from Optics for 2016 increased by $3,285,114 to $7,821,707 from $4,536,593 for the same period last year. The increase in net loss reflect, an increase in sales and marketing activities, and an increase in non-cash amortization and foreign exchange. The prior year figures also include a $1,450,000 gain on the revaluation of contingent shares.

Tactical

The Tactical division designs and sells a wide range of sophisticated surveillance and officer protection equipment and conducts surveillance training for the law enforcement and defense industries in the United States and Canada.

	2016	2015
Revenue	$2,237,213	$2,054,440
Net loss before income taxes	$(170,895)	$(134,240)

Revenues from Tactical for 2016 increased to $2,237,213 from $2,054,440 for 2015. The increased revenue for the year ended September 30, 2016 due largely to an increase in the foreign exchange rate in the current year.

Net loss before income taxes from Tactical for 2016 increased to $170,895 from $134,240 for 2015. The increased net loss before income taxes was a result of an increase in the foreign exchange rate in the current year.

QUARTERLY RESULTS

($ thousands, except common share amounts)	Q4 2016	Q3 2016	Q2 2016	Q1 2016	Q4 2015	Q3 2015	Q2 2015	Q1 2015
Revenue	$1,511	$1,158	$948	$1,509	$728	$1,359	$1,531	$1,534
Net loss	(1,677)	(1,957)	(2,450)	(1,746)	(1,565)	(1,280)	(895)	(931)
Net loss per common share:								
Basic	(0.03)	(0.04)	(0.05)	(0.03)	(0.03)	(0.03)	(0.02)	(0.02)
Diluted	(0.03)	(0.04)	(0.05)	(0.03)	(0.03)	(0.03)	(0.02)	(0.02)

There are no seasonal effects or other trends in the Company's business over the quarters presented. The increase in revenue in Q4 2016 was due to an OTF shipment during the quarter.

RELATED PARTY TRANSACTIONS

For the year ended September 30, 2016, the Company had no transactions with related parties as defined in IAS 24, *Related Party Disclosures,* except those pertaining to transactions with key management personnel in the ordinary course of their employment or as disclosed below.

(a) Remuneration of key management personnel:

	2016	2015
Salaries and employee benefits	$ 1,110,792	$ 866,094
Share based payments	487,925	433,096
	$ 1,598,717	$ 1,299,190

(b) Management fees totaling $500,604 (2015 - $320,620) charged by a company controlled by an officer and director of the Company, were included in salaries and benefits expense. As of September 30, 2016, amounts owing to this company included in accounts payable and accrued liabilities were $285,509 (2015 - $338,752).

(c) Legal and professional fees totaling $137,059 (2015 - $156,836) were incurred with a law firm of which a director of the Company is a partner. As of September 30, 2016, amounts owing to this company included in accounts payable and accrued liabilities were $52,826 (2015 - $171,895).

(d) During the year ended September 30, 2016 certain directors and officers of the Company participated in the convertible debentures financing amounting to $350,000 (2015 - $nil).

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

LIQUIDITY AND CAPITAL RESOURCES

The Company's principal sources of liquidity are cash provided by operations, including collection of accounts receivable, and access to equity capital resources. The Company's primary short-term cash requirement is to fund operations, working capital, including supplier payables, capital expenditures, and fixed overhead costs. Cash is also used to finance other long-term strategic business initiatives. As at September 30, 2016, cash and cash equivalents totaled $3,312,691, compared to $3,021,928 as at September 30, 2015.

Summary of Statement of Cash Flow

		2016	2015
Cash used in operating activities[1]	$	(4,181,875)	$ (3,090,250)
Changes in operating assets and liabilities		278,507	(302,203)
Cash used in operating activities		(3,903,368)	(3,392,453)
Cash used in investing activities		(148,752)	(912,493)
Cash provided by financing activities		4,317,689	3,487,137
Effect of foreign currency translation on cash and cash equivalents		25,194	(124,908)
Cash and cash equivalents, beginning of year		3,021,928	3,964,645
Cash and cash equivalents, end of year	$	3,312,691	$ 3,021,928

[1] Before changes in operating assets and liabilities

Operating Activities
Cash used in operating activities was $3,903,368 for the year ended September 30, 2016, compared to $3,392,453 last year. The increase in cash used relates primarily to an overall increase in operating costs.

Investing Activities
Cash used in investing activities was $148,752 for the year ended September 30, 2016, compared to $912,493 last year. The decrease relates to the completion of equipment upgrades early in the current year.

Financing Activities
Cash provided by financing activities was $4,317,689 for the year ended September 30, 2016, compared to $3,487,137 last year due to the issuance of a $4,120,289 convertible debenture in the current year compared to proceeds of a private placement of $2,613,312 in the previous year.

Contractual Obligations
Future contractual obligations as at September 30, 2016:

	Payments due by period		
	Total	Less than 1 year	1-3 years
Premises leases	$770,830	$255,690	$515,140

*Not including purchase commitments to suppliers

Capital Resources
The Company's objectives when managing capital are to safeguard the ability to continue as a going concern, to provide adequate return to shareholders, to meet external capital requirements, and preserve financial flexibility in order to benefit from potential opportunities that may arise. Our principal cash requirements are for operations, working capital, and capital expenditures. The Company has recurring operating losses and an accumulated deficit of $31,119,045 as of September 30, 2016 (September 30, 2015 - $23,289,240). As a result, the Company expects to incur significant losses in the next year unless it is able to realize revenue after commercialization of its products under development. The timing and amount of such revenues, if any, cannot be predicted with certainty. The Company's ability to continue as a going concern is dependent on its ability to generate positive cash flow or additional financing to meet its

planned business objectives and to be able to commercialize products currently in development. The Company will need to raise funds and is pursuing additional funds through grants, strategic collaborations, public or private equity or debt financing, or other funding sources. This funding may not be available on acceptable terms, or at all, and will most likely be dilutive to shareholder interests. If the Company is unable to generate positive cash flows or obtain adequate financing, the Company will need to curtail operations and development activities. These factors cast significant doubt regarding the Company's ability to continue as a going concern. Should the Company be unable to realize its assets and discharge its liabilities in the normal course of business the net realizable value of its assets may be materially less than the amounts on the Consolidated Statement of Financial Position.

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 are responsible for overseeing this process. In managing its capital, the Company considers changes in economic conditions, risks that impact consolidated operations, and future significant capital investment opportunities. For the year ended September 30, 2016, there were no other changes in our approach to capital management.

As at September 30, 2016 cash and cash equivalents amounted to $3,312,691, compared to $3,021,928 as at September 30, 2015.

The Company has a note payable outstanding of $3,000,000 as at September 30, 2016 compared to $3,000,000 last year. The note bears interest at 4% per annum and the principal is due in September 2017. Monthly interest payments are required prior to the maturity date. The note payable was used to finance some of the real estate assets acquired on the acquisition of Fortress Optical Features Ltd. The note payable is secured by the assets of the Company. The Company plans to repay or refinance the secured note through future debt or equity financing.

The Company has convertible debentures outstanding with a face value amounting to $4,185,000 as at September 30, 2016 which will be repaid upon maturity on May 31, 2018. The convertible debentures accrue interest at a rate of 12% per annum payable quarterly in arrears and are convertible into common shares of the Company at a price of $1.25 per share. The debentures are redeemable at the Company's option, at a price equal to their principal amount provided that the Company's common shares trade and close on the TSXV at or above $2.00 for ten consecutive days.

The Company had no commitments for material capital expenditures as of September 30, 2016.

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

Management has reviewed its projected funding requirements and expects that through the generation and collection of revenues and/or being able to raise additional financing, that the Company will maintain sufficient liquidity to meet its requirements through September 30, 2017.

Financial Instruments

The Company considers the management of financial risk to be an important part of its overall corporate risk management policy. The nature and extent of risks arising from financial instruments and their related risk management are described in note 12 of the Consolidated Financial Statements. In the year ended September 30, 2016, 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 share option plan ("Option Plan") and a restricted share unity plan ("RSU Plan") to grant options and restricted share units to eligible participants. The Option Plan permits the maximum number of shares that may be reserved for issuance at any point is

7% of issued and outstanding shares. The RSU Plan permits the maximum number of shares that may be reserved for issuance is fixed at 1,500,000.

During the year ended September 30, 2016, 796,500 (2015 - 530,000) options and 387,900 (2015 - 428,651) restricted share units were granted.

The common shares, options, and restricted share units outstanding and exercisable as at the following dates are:

	September 30, 2016		September 30, 2015	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Common shares outstanding	53,864,285		53,387,215	
Options				
Outstanding	2,488,500	$ 1.29	1,982,000	$ 1.30
Exercisable	1,954,625	$ 1.35	1,549,500	$ 1.35
RSUs				
Outstanding	451,030	N/A	319,598	N/A

As at December 14, 2016 the Company has 53,871,285 common shares issued and outstanding.

SIGNIFICANT ACCOUNTING POLICIES AND THE USE OF ESTIMATES

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

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

Going Concern

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

Fair Valuation of Financial Instruments

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

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

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

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

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

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

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

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

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

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

Property, Plant, and Equipment
Property, plant, and equipment is measured at cost less accumulated depreciation and accumulated impairment losses. Depreciation expense is recognized based on management's best estimate of the useful lives of the depreciable assets. The Company reviews the estimated useful life annually and recognizes any adjustment as appropriate. As at September 30, 2015, management revised its estimate useful life of its manufacturing equipment from 5% to 10% declining balance. The change in estimate has been accounted for on a prospective basis. While management believes that the estimates of useful lives of depreciable assets as at the balance sheet date are reasonable, differences in estimates could impact the valuation of depreciable assets and the results of operations of the Company.

NEW ACCOUNTING STANDARDS

In July 2014, the International Accounting Standards Board ("IASB") issued IFRS 9 – *Financial Instruments*, which replaces the earlier versions of IFRS 9 and completes the IASB's project to replace IAS 39 - *Financial Instruments: Recognition and Measurement*. IFRS 9 includes a logical model for classification and measurement of financial assets; a single, forward-looking 'expected credit loss' impairment model and a substantially-reformed approach to hedge accounting to better link the economics of risk management with its accounting treatment. IFRS 9 is effective for annual periods beginning on or after January 1, 2018 and must be applied retrospectively with some exemptions. Earlier adoption is permitted.

In May 2014, the IASB issued IFRS 15 - *Revenue from Contracts with Customers*, which supersedes IAS 18 - Revenue, IAS 11 - *Construction Contracts* and other interpretive guidance associated with revenue recognition. IFRS 15 provides a single, principles-based five-step model to be applied to all contracts with customers to determine how and when an entity should recognize revenue. The standard also provides guidance on whether revenue should be recognized at a point in time or over time as well as requirements for more informative, relevant disclosures. IFRS 15 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted.

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

The Company is currently evaluating the impact of these new accounting standards on its consolidated financial statements, and plans to adopt the new standards on the required effective date.

BUSINESS RISKS AND UNCERTAINTIES

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

History of Operating Losses and Negative Cash Flow

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

Financing Arrangements

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

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

Government Contracts and Funding

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

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

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

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

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

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

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

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

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

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

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

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

Security Environment

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

Insurance

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

ADDITIONAL INFORMATION

Outlook

Nanotech is a leader in next-generation anti-counterfeiting products. These products have brand protection and enhancement applications across a wide range of markets including banknotes, secure government documents, commercial branding, and the pharmaceutical industry. Nanotech is initially focusing its efforts on the banknote market due to its high margins and as its established customer base. Management continues to believe that the Company is well positioned to supply its Asian customer, however the additional time required for product acceptance and integration into their production processes has taken longer than anticipated. Once production resumes, it is expected to ramp up to supply this customer with significant colour-shifting OTF through the life of the banknote. The Company is focusing on further developing business with its established customer base and as a result, is well positioned to expand its development contract revenue in the years ahead.

Entering 2017, management has established a goal to double its revenue and make significant progress towards becoming cash flow positive. Achieving these results is not certain and involves known and unknown risks that may cause actual results to differ materially from this goal. These risks and uncertainties include, among other things, risks related to: uncertainty of amount and timing of purchase orders, the ability of Hueck to successfully deliver to our Asian customer, our ability to expand our Optics development revenue and our ability to maintain sufficient liquidity through September 30, 2017 to facilitate any business ramp-up. These and other risk factors are further discussed under the "Business Risks and Uncertainties" segment of the September 30, 2016 MD&A.

Public Securities Filings

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

Consolidated Financial Statements

(Expressed in Canadian Dollars)

Nanotech Security Corp.

Years ended September 30, 2016 and 2015

Nanotech Security Corp.
September 30, 2016 and 2015

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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Nanotech Security Corp.

We have audited the accompanying consolidated financial statements of Nanotech Security Corp., which comprise the consolidated statements of financial position as at September 30, 2016 and September 30, 2015, the consolidated statements of operations and comprehensive loss, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Nanotech Security Corp. as at September 30, 2016 and September 30, 2015, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards.

Emphasis of Matter

Without qualifying our opinion, we draw attention to note 1(b) to the consolidated financial statements which indicates that Nanotech Security Corp. has sustained a loss in the year ended September 30, 2016 and in recent years and Nanotech Security Corp.'s ability to generate future profitable operations is uncertain. These conditions, along with other matters as set forth in note 1(b) to the consolidated financial statements, indicate the existence of a material uncertainty that may cast significant doubt about Nanotech Security Corp.'s ability to continue as a going concern.

KPMG LLP

Chartered Professional Accountants

December 19, 2016
Vancouver, Canada

Nanotech Security Corp.

Consolidated Statements of Operations and Comprehensive Loss
Years ended September 30, 2016 and 2015

(In Canadian dollars)

	2016	2015
Revenue	$ 5,126,109	$ 5,152,762
Cost of sales (note 17)	2,303,987	2,921,687
Gross profit	2,822,122	2,231,075
Expenses (note 17)		
Research and development	5,350,280	4,158,108
General and administration	2,655,457	2,455,131
Sales and marketing	2,369,258	1,884,113
	10,374,995	8,497,352
Loss before other expenses (income) and income taxes	(7,552,873)	(6,266,277)
Other expenses (income)		
Foreign exchange loss (gain)	78,793	(274,539)
Finance expense	360,936	129,095
Gain on revaluation of contingent shares (note 10)	-	(1,450,000)
	439,729	(1,595,444)
Loss before income taxes	(7,992,602)	(4,670,833)
Deferred income tax recovery (note 13)	162,797	-
Net loss	(7,829,805)	(4,670,833)
Other comprehensive income (loss):		
Items that may be subsequently reclassified to earnings:		
Unrealized foreign exchange gain (loss) on translation of foreign operation	24,654	(124,615)
Total comprehensive loss for the year	$ (7,805,151)	$ (4,795,448)
Loss per share		
Basic and diluted	$ (0.15)	$ (0.09)
Weighted average number of common shares		
Basic and diluted	53,524,646	49,404,777

See accompanying notes to Consolidated Financial Statements.

Nanotech Security Corp.

Consolidated Statements of Financial Position
as at September 30, 2016 and 2015

(In Canadian dollars)

	2016	2015
Assets		
Current assets:		
Cash and cash equivalents	$ 3,312,691	$ 3,021,928
Accounts receivable (note 12(b))	597,414	879,266
Inventory (note 5)	385,753	770,342
Prepaid expenses and other assets	127,719	76,840
	4,423,577	4,748,376
Property, plant and equipment (note 6)	17,338,312	18,921,396
Intangible assets (note 7(a))	1,361,239	2,725,629
Goodwill (note 7(b))	1,388,458	1,388,458
	$ 24,511,586	$ 27,783,859
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 1,395,568	$ 1,732,623
Note payable (note 8)	3,000,000	-
	4,395,568	1,732,623
Non-current liabilities:		
Convertible debentures (note 9)	3,595,142	-
Note payable (note 8)	-	3,000,000
Tenant inducement	98,793	126,363
	8,089,503	4,858,986
Shareholders’ equity		
Share capital (note 10)	45,210,507	44,666,497
Share based payment reserve	2,041,956	1,726,780
Equity component of convertible debentures (note 9)	443,175	-
Deficit	(31,119,045)	(23,289,240)
Accumulated other comprehensive loss	(154,510)	(179,164)
	16,422,083	22,924,873
	$ 24,511,586	$ 27,783,859

Nature of operations and going concern (note 1(b)).
Related party transactions (note 14).
See accompanying notes to Consolidated Financial Statements.

Approved on behalf of the Board of Directors:

"Doug Blakeway"	*"Ken Tolmie"*
Doug Blakeway, Director	Ken Tolmie, Director

Nanotech Security Corp.

Consolidated Statements of Changes in Equity
Years ended September 30, 2016 and 2015

(In Canadian dollars)

	Number of shares	Share capital	Share based payment reserve	Equity component of convertible debentures	Deficit	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at October 1, 2014	48,307,934	$ 39,557,066	$ 1,143,570	$ -	$ (18,618,407)	$ (54,549)	$ 22,027,680
Net loss	-	-	-	-	(4,670,833)	-	(4,670,833)
Unrealized foreign exchange loss on translation	-	-	-	-	-	(124,615)	(124,615)
Contingent shares issued (note 10(a))	1,500,000	1,650,000	-		-	-	1,650,000
Private placement (note 10(a))	2,655,000	2,613,312	-		-	-	2,613,312
Share-based payments (note 10(c) and (d))	-	-	693,354	-	-	-	693,354
RSUs vested (note 10(d))	106,531	110,144	(110,144)		-	-	-
Warrants exercised (note 10(e))	817,750	735,975	-	-	-	-	735,975
Balance as at September 30, 2015	53,387,215	$ 44,666,497	$ 1,726,780	$ -	$ (23,289,240)	$ (179,164)	$ 22,924,873
Net loss	-	-	-	-	(7,829,805)	-	(7,829,805)
Unrealized foreign exchange loss on translation	-	-	-	-	-	24,654	24,654
Fair value of equity component of convertible debentures on issuance, net of transaction costs (note 9)	-	-	-	605,972	-	-	605,972
Deferred tax liability relating to convertible debentures (note 9)	-	-	-	(162,797)	-	-	(162,797)
Share based payments (note 10(c) and (d))	-	-	661,786	-	-	-	661,786
RSUs vested (note 10(d))	237,070	258,406	(258,406)		-	-	-
Options exercised (note 10(c))	240,000	285,604	(88,204)	-	-	-	197,400
Balance as at September 30, 2016	53,864,285	$ 45,210,507	$ 2,041,956	$ 443,175	$ (31,119,045)	$ (154,510)	$ 16,422,083

See accompanying notes to Consolidated Financial Statements.

Nanotech Security Corp.

Consolidated Statements of Cash Flows
Years ended September 30, 2016 and 2015

(In Canadian dollars)

	2016	2015
Cash flows provided by (used in):		
Operating activities:		
Net loss	$ (7,829,805)	$ (4,670,833)
Items not involving cash:		
Depreciation and amortization	3,095,686	2,348,716
Share based compensation	661,786	693,354
Deferred income taxes	(162,797)	-
Amortization of tenant inducement	(27,570)	(11,487)
Accretion of convertible debentures	80,825	-
Gain on revaluation of contingent shares	-	(1,450,000)
Non-cash working capital changes (note 15(a))	278,507	(302,203)
Cash used in operating activities	(3,903,368)	(3,392,453)
Investing activities:		
Purchase of property and equipment, net of tax credits	(148,752)	(912,493)
Cash used in investing activities	(148,752)	(912,493)
Financing activities:		
Issuance of shares for options exercised	197,400	-
Proceeds on issuance of convertible debentures, net of costs (note 9)	4,120,289	-
Proceeds of private placement, net of share issuance costs (note 10)	-	2,613,312
Issuance of shares for warrants exercised	-	735,975
Tenant inducement	-	137,850
Cash provided by financing activities	4,317,689	3,487,137
Effect of foreign exchange on cash and cash equivalents	25,194	(124,908)
Increase (decrease) in cash and cash equivalents	290,763	(942,717)
Cash and cash equivalents, beginning of year	3,021,928	3,964,645
Cash and cash equivalents, end of year	$ 3,312,691	$ 3,021,928

See accompanying notes to Consolidated Financial Statements.

1. Summary of business and nature of operations:

(a) *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 ("TSXV") (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 is a global optics company, focusing on light based recognition nano-optics and optical thin film ("OTF") for use in authentication and brand enhancement products including currency, legal documents, and commercial products. Its wholly-owned subsidiary, Tactical Technologies Inc. ("TTI"), designs and sells sophisticated surveillance and officer protection equipment for the law enforcement and defense industries primarily in the United States.

(b) *Nature of operations and going concern*

These consolidated financial statements have been prepared on the basis that the Company will continue as a going concern. The Company has recurring operating losses and an accumulated deficit of $31,119,045 as of September 30, 2016 ($23,289,240 as of September 30, 2015). The Company expects to continue to incur substantial expenses relating to its research and development efforts in nano-optics and OTF. As a result, the Company may incur losses in the next few years until it is able to realize revenue. The timing and amount of such revenues, if any, cannot be predicted with certainty.

The Company's ability to continue as a going concern is dependent on its ability to generate positive cash flows or additional financing in order to meet its planned business objectives and to be able to commercialize future products currently in development. The Company may need to raise funds through grants, strategic collaborations, public or private equity, debt financing, or other funding sources. This funding may not be available on acceptable terms, or at all, and may be dilutive to shareholder interests. If the Company is unable to generate positive cash flows or obtain adequate financing, the Company may need to curtail operations and development activities. These factors cast significant doubt on the Company's ability to continue as a going concern. Should the Company be unable to realize its assets and discharge its liabilities in the normal course of business, the net realizable value of its assets may be materially less than the amounts on the Consolidated Statement of Financial Position.

2. Basis of preparation:

(a) *Statement of compliance:*

These consolidated financial statements have been prepared on a going concern basis in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards board ("IASB"). The financial statements were approved by the Company's Board of Directors and authorized for issue on December 14, 2016.

2. Basis of preparation (continued):

(b) *Basis of measurement:*

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

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

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

(i) Valuation of goodwill:

Goodwill arising on an acquisition of a business is carried at cost as established at the date of acquisition of the business less impairment losses, if any. For purposes of impairment testing, goodwill is allocated to each of the Company's cash-generating units (or groups of cash-generating units) that is expected to benefit from the synergies of the combination. A cash-generating unit to which goodwill has been allocated is tested for impairment annually, or more frequently when there is an indication that the cash-generating unit may be impaired. Management evaluates goodwill for impairment annually as of September 30th. While management uses their best estimate and assumptions to assess goodwill impairment, there are inherent uncertainties in projecting future cash flows.

(ii) Judgments:

Management uses judgment when applying accounting policies and when making estimates and assumptions as described above. The most significant areas that require judgment include determination of functional currency, the estimated useful life of property, plant and equipment and intangibles, determination of cash generating units and segments, and assessing the Company's ability to continue as a going concern.

3. Significant accounting policies:

(a) *Basis of consolidation:*

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

3. Significant accounting policies (continued):

(b) *Foreign currency translation:*

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

(i) Transactions in foreign currency:

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

(ii) Foreign operations translation:

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

(c) *Revenue recognition:*

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

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

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

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

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

3. Significant accounting policies (continued):

(c) *Revenue recognition (continued):*

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

(d) *Earnings per common share:*

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

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

(e) *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, 2016 and 2015, all development costs have been expensed.

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

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

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

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

(g) *Financial instruments:*

Financial assets and financial liabilities are initially measured at fair value and are subsequently re-measured based on their classification as described below. Transaction costs that are directly

3. Significant accounting policies (continued):

(g) *Financial instruments (continued):*

attributable to the acquisition or issuance of a financial asset or liability, other than financial assets and liabilities recorded at fair value through earnings, are added or deducted from the fair value of the respective financial asset or financial liability on initial recognition. Transaction costs that are directly attributable to the acquisition of a financial asset or financial liability recorded at fair value through earnings are recognized immediately in earnings.

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

(i) Financial assets:

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

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

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

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

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

3. Significant accounting policies (continued):

(g) *Financial instruments (continued):*

(ii) Financial liabilities:

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

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

(iii) Compound instruments:

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

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

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

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

(iv) Embedded derivatives:

Derivatives embedded in non-derivative host contracts are treated as separate derivatives when they meet the definition of a derivative, their risks and characteristics are not closely related to those of the host contracts and the contracts are not measured at the fair value through earnings.

Embedded derivatives are recorded at the fair value through earnings. During the years ended September 30, 2016 and 2015, the Company did not have any embedded derivatives.

(h) *Cash and cash equivalents:*

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

(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(i) *Inventory:*

Inventory is measured at the lower of cost and net realizable value and consists primarily of raw materials used in the manufacturing of surveillance equipment and OTF. Raw materials cost is determined on a weighted average basis. The cost of work in process 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.

(j) *Property, plant and equipment:*

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

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

The Company reviews the estimated useful lives and the depreciation methods of its property, plant and equipment annually. At September 30, 2015 management revised its estimated useful life of manufacturing equipment from 5% to 10% declining balance. The change in estimate was accounted for on a prospective basis.

(k) *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, 2016 and 2015, 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.

3. Significant accounting policies (continued):

(l) *Impairment:*

(i) Financial assets:

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

(ii) Non-financial assets:

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

(m) *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.

3. Significant accounting policies (continued):

(n) *Share-based payments:*

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

(o) *Restricted share units:*

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

(p) *Income taxes:*

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

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

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

3. Significant accounting policies (continued):

(p) *Income taxes (continued):*

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.

(q) *Leases:*

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

4. New standards and interpretations not yet adopted:

(a) *IFRS 9 – Financial Instruments:*

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

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

In May 2014, the IASB issued IFRS 15 – *Revenue from Contracts with Customers*, which supersedes IAS 18 – *Revenue,* IAS 11 – *Construction Contracts* and other interpretive guidance associated with revenue recognition. IFRS 15 provides a single, principles-based five-step model to be applied to all contracts with customers to determine how and when an entity should recognize revenue. The standard also provides guidance on whether revenue should be recognized at a point in time or over time as well as requirements for more informative, relevant disclosures. IFRS 15 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. The Company is currently evaluating the impact of IFRS 15 on its financial statements, and plans to adopt the new standard on the required effective date.

(Expressed in Canadian dollars)

4. New standards and interpretations not yet adopted (continued):

(c) *IFRS 16 – Leases:*

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

5. Inventory:

	2016	2015
Raw materials	$ 309,055	$ 408,703
Work in progress	76,698	258,227
Finished goods	-	103,412
	$ 385,753	$ 770,342

In 2016, the write-down of inventories to net realizable value amounted to $104,524 (2015 - $160,371). There were no reversals of previously recorded write-downs in 2016 and 2015. For the year ended September 30, 2016, the Company recognized inventories of $1,199,306 (2015 - $1,273,116) as expenses through cost of sales.

(Expressed in Canadian dollars)

6. Property, plant and equipment:

	Land	Building and leasehold improvement	Manufacturing equipment	Laboratory, software, and office equipment	Total
Cost:					
Balance as at October 1, 2014	141,700	3,646,317	15,149,121	531,515	19,468,653
Additions	-	160,469	631,656	120,368	912,493
Disposals	-	(4,137)	-	(174,562)	(178,699)
Foreign currency translation	-	5,212	-	77,439	82,651
Balance as at September 30, 2015	141,700	3,807,861	15,780,777	554,760	20,285,098
Additions	-	-	142,179	6,573	148,752
Disposals	-	-	-	(35,372)	(35,372)
Foreign currency translation	-	(483)	-	(5,548)	(6,031)
Balance as at September 30, 2016	$ 141,700	$ 3,807,378	$ 15,922,956	$ 520,413	$ 20,392,447
Accumulated depreciation:					
Balance as at October 1, 2014	-	32,793	30,876	409,663	473,332
Depreciation expense	-	151,227	771,704	63,150	986,081
Disposals	-	(4,137)	-	(174,562)	(178,699)
Foreign currency translation	-	5,212	-	77,776	82,988
Balance as at September 30, 2015	-	185,095	802,580	376,027	1,363,702
Depreciation expense	-	169,516	1,504,929	56,851	1,731,296
Disposals	-	-	-	(35,372)	(35,372)
Foreign currency translation	-	(483)	-	(5,008)	(5,491)
Balance as at September 30, 2016	$ -	$ 354,128	$ 2,307,509	$ 392,498	$ 3,054,135
Net book value:					
September 30, 2016	$ 141,700	$ 3,453,250	$ 13,615,447	$ 127,915	$ 17,338,312
September 30, 2015	$ 141,700	$ 3,622,766	$ 14,978,197	$ 178,733	$ 18,921,396

(Expressed in Canadian dollars)

7. Intangible assets and goodwill:

(a) Finite life intangible assets:

Cost:	
Balance as at October 1, 2014	$ 5,508,997
Dispositions	(44,904)
Foreign currency translation	12,266
Balance as at September 30, 2015	5,476,359
Dispositions	(31,405)
Balance as at September 30, 2016	$ 5,444,954
Accumulated amortization:	
Balance as at October 1, 2014	$ 1,421,363
Amortization expense	1,362,635
Dispositions	(44,904)
Foreign currency translation	11,636
Balance as at September 30, 2015	2,750,730
Amortization expense	1,364,390
Dispositions	(31,405)
Balance as at September 30, 2016	$ 4,083,715
Net book value:	
September 30, 2016	$ 1,361,239
September 30, 2015	$ 2,725,629

Amortization expense in the amount of $1,361,239 (2015 - $1,361,239) has been included in research and development expense.

(b) Goodwill impairment:

The Company performs a goodwill impairment test at least annually on September 30 and whenever there is an indication of impairment. No impairment of goodwill was identified as a result of the Company's most recent annual impairment tests. The Company conducts goodwill impairment testing based on one cash generating unit representing the Optics business segment (note 16).

(Expressed in Canadian dollars)

7. Intangible assets and goodwill (continued):

(b) Goodwill impairment (continued):

The key assumptions used in performing the impairment tests:

Segment	Valuation method	Discount rate		Perpetual growth rate	
		2016	2015	2016	2015
Optics	Value in use	12%	12%	1.0% - 2.0%	1.0% - 2.0%

- Recoverable amount:
  Management's past experience and future expectations of the business performance are used to make a best estimate of the expected revenues, earnings before interest, taxes, depreciation and amortization, and operating cash flows covering a five year forecast period, with a terminal value extrapolated into the future over the estimated useful life of the CGA using a steady growth rate.

- Discount rate:
  The discount rate applied is a pre-tax rate which reflects the time value of money and risk associated with the business. Management has determined its discount rate to reflect the risk of an emerging technology company.

- Perpetual growth rate:
  The perpetual growth rate is management's current assessment of the long-term growth prospect of the Company in the jurisdictions in which it operates.

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

8. Note payable:

The note payable is fully secured against the assets of the Company. It bears interest at a fixed rate of 4% per annum and is repayable in interest only with payment of the principal due on September 16, 2017.

(Expressed in Canadian dollars)

9. Convertible debentures:

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

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

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

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

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

The effective interest rate applied to accrete the carrying value of the debt-host instrument to the redemption value upon maturity is approximately 22.3%.

At September 30, 2016 the convertible debentures had a fair value of approximately $3,700,000.

(Expressed in Canadian dollars)

10. Share capital:

(a) Share capital:

Authorized:

Unlimited number of common shares with no par value.
Unlimited number of preferred shares with no par value.

Common shares issued and outstanding:

	Number of shares		Amount
Balance as at October 1, 2014	48,307,934	$	39,557,066
Contingent shares issued	1,500,000		1,650,000
Private placement	2,655,000		2,613,312
RSUs vested	106,531		110,144
Warrants exercised	817,750		735,975
Balance as at September 30, 2015	53,387,215		44,666,497
RSUs vested	237,070		258,406
Options exercised	240,000		285,604
Balance as at September 30, 2016	53,864,285	$	45,210,507

On July 17, 2015, the Company released 1.5 million of the 3.0 million contingent shares previously held in escrow. The remaining 1.5 million contingently issuable shares were cancelled. This resulted in a gain on the revaluation of the contingent share obligation of $780,000 and a gain on the settlement of the obligation of $670,000 for the year ended September 30, 2015.

On August 26, 2015, the Company completed a private placement financing for total proceeds of $2,655,000, for the issuance of 2,655,000 equity units. The Company incurred share issue costs of $41,688. Each equity unit consists of one common share and one-half of one common share purchase warrant, with each whole warrant entitling the holder to purchase one common share of the Company at a price of $1.50 per share until February 26, 2017.

(b) Share-based payment plans:

(i) Share option plan

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

(ii) Restricted share unit plan

On January 28, 2015, the Company adopted a RSU plan. Under the plan the maximum number of shares that may be reserved for issuance is fixed at 1,500,000. 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.

(Expressed in Canadian dollars)

10. Share capital (continued):

(c) Stock option plan:

Stock options outstanding as at September 30, 2016:

	Number of options	Weighted average exercise price
Balance as at October 1, 2014	1,567,000	$ 1.38
Granted	530,000	1.15
Forfeited	(115,000)	1.58
Balance as at September 30, 2015	1,982,000	1.30
Granted	796,500	1.14
Exercised	(240,000)	0.82
Expired	(50,000)	1.70
Balance as at September 30, 2016	2,488,500	$ 1.29

The following table summarizes information pertaining to the Company's stock options outstanding as at September 30, 2016:

Options outstanding				Options exercisable	
Range of exercise prices CDN$	Number of options outstanding	Weighted average remaining contractual life (yrs)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
$0.00 - $1.00	257,000	0.00	$ 0.80	257,000	$ 0.80
$1.01 - $1.75	2,231,500	3.41	1.34	1,697,625	1.42
	2,488,500	3.06	$ 1.29	1,954,625	$ 1.35

The original term of the 257,000 stock options expired on September 30, 2016 and the term has been extended to a date still to be determined.

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

(Expressed in Canadian dollars)

10. Share capital (continued):

(c) Stock option plan (continued):

The weighted average assumptions used to estimate the fair value of options granted during the years ended September 30, 2016 and 2015:

	2016	2015
Risk free interest rate	0.66%	0.69%
Expected life	4.30	4.37
Vesting period	1.5 years	1.5 years
Expected volatility	50%	54%
Expected dividends	nil	nil
Average fair value	$0.47	$0.48
Forfeiture rate	10.2%	8.5%

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

	2016	2015
Total compensation – stock options	$ 290,280	$ 473,098

(d) Restricted share unit plan:

During the year ended September 30, 2015, the Company granted 423,955 and 4,695 RSUs to employees and directors with a fair value of $1.15 and $1.04 per share respectively. 25% of these RSUs vested on September 1, 2015, 35% vested on September 1, 2016, and the remaining 40% will vest on September 1, 2017.

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

(Expressed in Canadian dollars)

10. Share capital (continued):

(d) Restricted share unit plan (continued):

RSUs outstanding as at September 30, 2016:

	Number of RSUs
Balance as at October 1, 2014	-
Granted	428,651
Forfeited	(2,522)
Vested	(106,531)
Balance as at September 30, 2015	319,598
Granted	387,900
Forfeited	(19,398)
Vested	(237,070)
Balance as at September 30, 2016	451,030

Using an estimated forfeiture rate of 10% for the years ended September 30, 2016 and September 30, 2015, the Company charged the following share-based payments to operating expenses in connection with the Company's RSU plan, with a corresponding increase in the share-based payment reserve:

	2016	2015
Total compensation - RSUs	$ 371,506	$ 220,256

(e) Warrants:

Warrants outstanding as at September 30, 2016 are as follows:

	Number of warrants	Weighted average exercise price
Balance as at October 1, 2014	6,013,176	$ 1.49
Granted on private placement	1,327,500	1.50
Expired private placement warrants	(4,936,076)	1.59
Expired work fee warrants	(259,350)	1.50
Exercised	(817,750)	0.90
Balance as at September 30, 2015	1,327,500	$ 1.50
Balance as at September 30, 2016	1,327,500	$ 1.50

The remaining warrants expire on February 26, 2017.

11. Capital risk management:

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

The capital of the Company consists of the items included in the Consolidated Balance Sheets in the shareholders' equity section, the secured note payable and convertible debenture.

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

12. Financial instruments and risk exposures:

(a) Fair value measurement:

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

Cash and cash equivalents and accounts receivable are classified as loans and receivables, measured at amortized cost using the effective interest rate method. Accounts payable and accrued liabilities, secured note payable, and the convertible debenture 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.

Contingent share consideration is valued as at the balance sheet date based upon the share value as determined by the trading value on the TSXV.

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

(Expressed in Canadian dollars)

12. Financial instruments and risk exposures (continued):

(b) Credit risk (continued):

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, 2016, the balance of the allowance account for credit losses was $nil (2015 - $nil).

Pursuant to their respective terms, accounts receivable was aged as at September 30, 2016 and 2015:

	2016	2015
0 - 30 days	$ 399,771	$ 657,807
31 - 60 days	57,638	24,045
61 - 90 days	140,005	6,521
Greater than 90 days	-	190,893
Total accounts receivable	$ 597,414	$ 879,266

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

There is a possibility of increased customer credit risk due to the ongoing global recessionary trends. As at September 30, 2016, the Company's accounts receivable are made up of approximately 37% (2015 - 38%) government trade receivables and the balance of the outstanding accounts receivable are spread over a large number of customers.

The Company may also have credit risk relating to cash and cash equivalents, which it manages by dealing with large banks and investing in highly liquid investments. The Company's objective is to minimize its 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, 2016 totaled $3,312,691 (2015 - $3,021,928), and accounts receivables of $597,414 (2015 - $879,266), representing the maximum exposure to credit risk of these financial assets.

12. Financial instruments and risk exposures (continued):

(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, 2016, the Company had cash and cash equivalents of $3,312,691 (2015 - $3,021,928) and accounts receivable of $597,414 (2015 - $879,266) for a total of $3,910,105 (2015 - $3,901,194). The liquidity and additional financing are adequate for the settlement of short-term financial obligations.

(d) Currency risk:

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

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

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

(e) Interest rate risk:

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

(Expressed in Canadian dollars)

13. Income taxes:

(a) Income tax expense:

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

	2016	2015
Loss before income taxes	$ (7,992,602)	$ (4,670,833)
Statutory tax rate	26.45%	26.45%
Calculated tax benefit	(2,114,043)	(1,235,435)
Effective tax rate change and other	(137,202)	(113,399)
Permanent differences	182,051	(221,036)
Change in unrecognized deferred tax assets	1,906,397	1,569,870
Income tax recovery	$ (162,797)	$ -

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

(b) Recognized deferred tax assets and liabilities:

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

	2016	2015
Deferred tax assets:		
Non-capital losses carried forward	$ 3,241,390	$ 3,082,976
Deferred tax liabilities:		
Property, plant, and equipment and intangible assets	(3,085,593)	(3,082,976)
Convertible debentures	(155,797)	
Net deferred tax asset	$ -	$ -

(Expressed in Canadian dollars)

13. Income taxes (continued):

(c) Deferred income tax assets and liabilities:

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

	2016	2015
Non-capital loss carry forwards	$ 8,386,489	$ 2,769,755
Net capital loss carry forwards	2,385,221	2,385,221
Other temporary differences	6,398,843	5,257,070
Unrecognized deferred income tax assets	$ 17,170,553	$ 10,412,046

(d) Loss carry forwards:

As at September 30, 2016, the Company has Canadian tax loss carry forwards of approximately $19,160,000 (2015 - $13,250,000). As at September 30, 2016, the Company has United States loss carry forwards of approximately $1,390,000 (2015 - $1,180,000). The Company's tax loss carry forwards will expire, if not utilized, commencing in 2027. The Company recognizes the benefit of tax losses only to the extent of anticipated future taxable income in the relevant jurisdiction.

(e) R&D and tax credit attributes:

As at September 30, 2016, the Company had unclaimed tax deductions of scientific research and experimental development expenditures of $1,550,000 (2015 - $1,210,000) that is available to reduce taxable income in future years and may be carried forward indefinitely. As at September 30, 2016, the Company has Federal investment tax credits of $340,000 (2015 - $270,000) that may be carried forward to apply against future years' income tax payable. These investment tax credits begin to expire in 2031.

14. Related party transactions:

(a) Remuneration of key management personnel:

	2016	2015
Salaries, accrued bonuses, and employee benefits	$ 1,110,792	$ 866,094
Share-based payments	487,925	433,096
	$ 1,598,717	$ 1,299,190

(Expressed in Canadian dollars)

14. Related party transactions (continued):

(b) Management fees totaling $500,604 (2015 - $320,620) charged by a company controlled by an officer and director of the Company, were included in salaries and benefits expense. As of September 30, 2016, amounts owing to this company included in accounts payable and accrued liabilities were $285,509 (2015 - $338,752).

(c) Legal and professional fees totaling $137,059 (2015 - $156,836) were incurred with a law firm of which a director of the Company is a partner. As of September 30, 2016, amounts owing to this company included in accounts payable and accrued liabilities were $52,826 (2015 - $171,895).

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

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

15. Supplementary cash flow information:

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

	2016	2015
Accounts receivable	$ 281,852	$ (352,856)
Inventory	384,589	(171,816)
Prepaid expenses and other assets	(50,879)	112,018
Accounts payable and accrued liabilities	(337,055)	110,451
	$ 278,507	$ (302,203)

(b) Interest and income taxes:

During the year ended September 30, 2016, the Company paid $276,253 (2015 - $123,384) in interest. During the years ended September 30, 2016 and 2015, the Company did not pay any income taxes.

(Expressed in Canadian dollars)

16. Segmented information:

The Company's business operates primarily through two business segments – Optics (previously named Security Features) and Tactical (previously named Surveillance). These operating segments are monitored by the Company's chief operating decision makers and strategic decisions are made on the basis of segment operating results.

Optics focuses on light based recognition nano-optics and OTF for use in authentication and brand enhancement products including currency, secure documents, and commercial products.

Tactical designs and sells sophisticated surveillance and officer protection equipment for the law enforcement and defense industries in the United States and Canada.

The Company's reportable segments are strategic business units that offer different products and services. They are managed separately as each business is in a different stage in its life cycle and they require different sales and marketing strategies.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

During the year ended September 30, 2016, the Company had three customers who each represented greater than 10% of total revenues. Those customers represented approximately 32%, 17%, and 14% of total revenues and had sales from our Optics and Tactical segments. (2015 - three customers represented approximately 19%, 19% and 14% of the total revenue from our Optics segment).

September 30, 2016	Optics	Tactical	Total
Total current assets	$ 3,920,822	$ 502,755	$ 4,423,577
Property, plant and equipment	17,306,698	31,614	17,338,312
Intangible assets	1,361,239	-	1,361,239
Goodwill	1,388,458	-	1,388,458
Total current liabilities	4,319,162	76,406	4,395,568
Total liabilities	8,013,097	76,406	8,089,503

September 30, 2015	Optics	Tactical	Total
Total current assets	$ 3,889,907	$ 858,469	$ 4,748,376
Property, plant and equipment	18,881,278	40,118	18,921,396
Intangible assets	2,722,477	3,152	2,725,629
Goodwill	1,388,458	-	1,388,458
Total current liabilities	1,440,121	292,502	1,732,623
Total liabilities	4,566,484	292,502	4,858,986

(Expressed in Canadian dollars)

16. Segmented information (continued):

Year ended September 30, 2016	Optics	Tactical	Total
Revenue	$ 2,888,896	$ 2,237,213	$ 5,126,109
Cost of sales	884,132	1,419,855	2,303,987
Gross profit	2,004,764	817,358	2,822,122
Expenses	9,392,958	982,037	10,374,995
Other expenses	433,513	6,216	439,729
Loss before income taxes	(7,821,707)	(170,895)	(7,992,602)

Year ended September 30, 2015	Optics	Tactical	Total
Revenue	$ 3,098,322	$ 2,054,440	$ 5,152,762
Cost of sales	1,397,618	1,524,069	2,921,687
Gross profit	1,700,704	530,371	2,231,075
Expenses	7,688,123	809,229	8,497,352
Other income	(1,450,826)	(144,618)	(1,595,444)
Loss before income taxes	(4,536,593)	(134,240)	(4,670,833)

(Expressed in Canadian dollars)

17. Nature of expenses:

Cost of sales and expenses:

	For the years ended September 30,	
	2016	2015
Cost of sales:		
Direct cost of sales	2,222,338	2,763,332
Depreciation and amortization	81,649	158,355
	2,303,987	2,921,687
Research and development:		
Direct expenses	2,409,106	2,193,575
Depreciation and amortization	2,964,789	2,173,283
Government grants	(23,615)	(208,750)
	5,350,280	4,158,108
General and administration:		
Direct expenses	2,606,209	2,438,053
Depreciation and amortization	49,248	17,078
	2,655,457	2,455,131
Sales and marketing:		
Direct expenses	2,369,258	1,884,113
	2,369,258	1,884,113
Supplementary information:		
Salaries and benefits	4,842,135	5,737,577
Share-based compensation	661,786	693,354

The Company reclassified certain items in the Consolidated Statements of Operations and Comprehensive Loss for the year ended September 30, 2015 to conform to the current year's presentation. This reclassification had no impact on the net loss or total comprehensive loss.

18. Commitments:

(a) As at September 30, 2016, the Company is committed under operating leases, primarily related to office space, for the following minimum annual rentals:

2017	$	255,690
2018		197,438
2019		200,654
2020		117,048
Thereafter		-
	$	770,830

(b) Certain nano-optic products are subject to a 3% sales royalty in favor of Simon Fraser University where certain elements of the nano-optic technology originated.