



Financial Statements

September 30, 2017



Consolidated Financial Statements of

Nanotech Security Corp.

Years ended September 30, 2017 and 2016

Nanotech Security Corp.
September 30, 2017 and 2016

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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Nanotech Security Corp.

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

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

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



*Shareholders
Nanotech Security Corp.
Independent Auditors' Report*

Opinion

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

A handwritten signature in black ink that reads 'KPMG LLP' in a cursive, slanted font. A horizontal line is drawn underneath the signature.

Chartered Professional Accountants

December 21, 2017
Vancouver, Canada

Nanotech Security Corp.

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

(In Canadian dollars)

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

See accompanying notes to Consolidated Financial Statements.

Nanotech Security Corp.

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

(In Canadian dollars)

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

Related party transactions (note 14).

Commitments (note 17).

See accompanying notes to Consolidated Financial Statements.

Approved on behalf of the Board of Directors:

"Doug Blakeway"

Doug Blakeway, Director

"Ken Tolmie"

Ken Tolmie, Director

Nanotech Security Corp.

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

(In Canadian dollars)

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

See accompanying notes to Consolidated Financial Statements.

Nanotech Security Corp.

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

(In Canadian dollars)

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

See supplementary cash flow information (note 15).

See accompanying notes to Consolidated Financial Statements.

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

1. Summary of business:

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

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

2. Basis of preparation:

(a) *Statement of compliance:*

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

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

(b) *Basis of measurement:*

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

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

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

(i) Valuation of goodwill:

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

2. Basis of preparation (continued):

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

(i) Valuation of goodwill (continued):

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

(ii) Judgments:

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

(d) *Basis of consolidation:*

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

(e) *Foreign currency translation:*

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

(i) Transactions in foreign currency:

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

(ii) Foreign operations translation:

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

3. Significant accounting policies:

(a) *Revenue recognition:*

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

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

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

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

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

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

(b) *Earnings per common share:*

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

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

(c) *Research and development:*

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

3. Significant accounting policies (continued):

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

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

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

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

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

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

(e) *Financial instruments:*

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

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

(i) *Financial assets:*

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

3. Significant accounting policies (continued):

(e) *Financial instruments (continued):*

(i) Financial assets (continued):

- **Financial assets at fair value through earnings:**
Financial assets are classified as at fair value through earnings when held for trading or if designated into this category. Financial assets classified as financial assets at fair value through earnings are measured at fair value with any gains or losses arising on remeasurement recognized in earnings. The Company does not have any financial assets classified as fair value through earnings.
- **Loans and receivables:**
Loans and receivables include cash and cash equivalents, and other receivables. Loans and receivables are initially measured at fair value and are subsequently remeasured at amortized cost using the effective interest method, less any impairment losses. The Company has classified cash and cash equivalents and accounts receivables as loans and receivables.
- **Available-for-sale financial assets:**
Available-for-sale financial assets are non-derivative financial assets that are either designated in this category or not classified into any of the other categories. Available-for-sale financial assets are measured at fair value with any gains or losses on remeasurement recognized in other comprehensive income until the financial asset is derecognized or is determined to be permanently impaired, at which time the gain or loss accumulated in equity is transferred to earnings. The Company does not have any financial assets classified as available-for-sale assets.

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

(ii) Financial liabilities:

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

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

(iii) Compound instruments:

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

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

3. Significant accounting policies (continued):

(e) *Financial instruments (continued):*

(iii) Compound instruments (continued):

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

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

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

(iv) Embedded derivatives:

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

(f) *Cash and cash equivalents:*

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

(g) *Inventory:*

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

3. Significant accounting policies (continued):

(h) *Property, plant and equipment:*

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

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

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

(i) *Intangible assets and goodwill:*

(i) Intangible assets:

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

(ii) Goodwill:

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

(j) *Impairment:*

(i) Financial assets:

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

3. Significant accounting policies (continued):

(j) *Impairment (continued):*

(i) Financial assets (continued):

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

(ii) Non-financial assets:

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

(k) *Provisions:*

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

(l) *Share-based payments:*

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

Nanotech Security Corp.

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

Years ended September 30, 2017 and 2016

3. Significant accounting policies (continued):

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

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

(m) *Restricted share units:*

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

(n) *Income taxes:*

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

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

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

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

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

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3. Significant accounting policies (continued):

(o) *Leases:*

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

(p) *Segment reporting:*

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

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

(i) *Assets held for sale:*

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

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

(ii) *Discontinued operations:*

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

Nanotech Security Corp.

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3. Significant accounting policies (continued):

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

(ii) Discontinued operations (continued):

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

4. New standards and interpretations not yet adopted:

(a) *IFRS 9 – Financial Instruments:*

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

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

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

(c) *IFRS 16 – Leases:*

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

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5. Inventory:

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

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

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

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

Nanotech Security Corp.

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6. Property, plant and equipment:

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

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

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
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7. Intangible assets and goodwill:

(a) Goodwill impairment:

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

The key assumptions used in performing the impairment tests:

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

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

Nanotech Security Corp.

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7. Intangible assets and goodwill (continued):

(b) *Finite life intangible assets:*

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

8. Note payable:

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

9. Convertible debentures:

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

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

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

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9. Convertible debentures (continued):

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

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

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

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

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

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

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9. Convertible debentures (continued):

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

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

10. Share capital:

(a) Share capital:

Authorized:

Unlimited number of common shares with no par value

Unlimited number of preferred shares with no par value

Common shares issued and fully paid:

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

There are no preferred shares issued and outstanding.

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

(b) Share-based payment plans:

(i) Share option plan

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

(ii) Restricted share unit plan

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

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
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10. Share capital (continued):

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

(ii) Restricted share unit plan (continued)

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

(c) *Stock option plan:*

Stock options outstanding as at September 30, 2017:

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

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

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

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

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10. Share capital (continued):

(c) Stock option plan (continued):

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

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

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

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

(d) Restricted share unit plan:

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

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

RSUs outstanding as at September 30, 2017:

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

Nanotech Security Corp.

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10. Share capital (continued):

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

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

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

(e) *Warrants:*

Warrants outstanding as at September 30, 2017:

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

11. Capital risk management:

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

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

12. Financial instruments and risk exposures:

(a) *Fair value measurement:*

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

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

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12. Financial instruments and risk exposures (continued):

(a) Fair value measurement (continued):

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

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

(b) Credit risk:

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

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

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

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

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

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

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

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

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

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

Nanotech Security Corp.

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12. Financial instruments and risk exposures (continued):

(b) *Credit risk (continued):*

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

(c) *Liquidity risk:*

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

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

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

(d) *Currency risk:*

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

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

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

(e) *Interest rate risk:*

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

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13. Income taxes:

(a) *Income tax expense:*

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

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

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

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

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

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

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

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

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

Nanotech Security Corp.

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13. Income taxes (continued):

(d) *Loss carry forwards:*

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

(e) *Discontinued operations:*

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

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

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

14. Related party transactions:

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

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

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

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

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

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

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15. Supplementary cash flow information:

(a) Change in non-cash working capital:

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

(b) Interest and income taxes:

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

(c) Cash and cash equivalents:

Cash and cash equivalents are comprised of:

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

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

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

16. Nature of expenses:

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

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

Nanotech Security Corp.

Notes to the Consolidated Financial Statements
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17. Commitments:

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

2018	\$ 2,288,093
2019	200,654
2020	117,048
	<u>\$ 2,605,795</u>

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

18. Discontinued operations:

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

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

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

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18. Discontinued operations (continued):

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

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

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