



Consolidated Financial Statements of

PHOTON CONTROL INC.

For the nine months ended September 30, 2016 and 2015

NOTICE OF NO-AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, “Continuous Disclosure Obligations”, Part 4, subsection 4.3(3) (a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The Company’s external auditors, MNP LLP, have not performed a review of these financial statements.

PHOTON CONTROL INC.

Consolidated Statements of Financial Position

(Expressed in Canadian dollars)

As at September 30, 2016 and December 31, 2015

	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 31,138,643	\$ 26,227,017
Trade accounts receivable and other	5,175,612	3,566,245
Note receivable - related (note 8(a))	18,566	18,566
Due from related party (note 8(a))	105,610	178,336
Inventory (note 4)	2,927,061	2,634,010
Prepaid expenses and deposits	365,737	36,832
	<u>39,731,229</u>	<u>32,661,006</u>
Property and equipment (note 5)	627,681	479,491
Intangible assets (note 6)	94,068	122,556
Long term rental deposits	34,695	34,695
Note receivable - related (note 8(a))	59,457	74,985
Restricted cash (note 13)	53,743	53,743
Deferred taxes	318,350	318,350
Total Assets	\$ 40,919,223	\$ 33,744,826
Liabilities and Shareholders' Equity		
Current liabilities:		
Deferred revenue	\$ 68,326	\$ 68,325
Accounts payable and accrued liabilities (note 15)	1,834,909	1,244,123
Corporate tax payable	173,462	610,462
Due to related party (note 8(a))	825,022	184,858
	<u>2,901,719</u>	<u>2,107,768</u>
Shareholders' equity (note 7):		
Share capital	28,941,555	28,217,623
Contributed surplus	4,186,106	3,694,121
Retained Earnings	4,889,843	(274,686)
	<u>38,017,504</u>	<u>31,637,058</u>
Litigation (note 16)		
Subsequent events (note 17)		
Total Liabilities and Shareholders' Equity	\$ 40,919,223	\$ 33,744,826

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board

"Michael Goldstein", Director

"Ronan McGrath", Director

PHOTON CONTROL INC.

Consolidated Statements of Comprehensive Income (Expressed in Canadian dollars)

For the nine months ended September 30, 2016 and 2015

	Three Months Ended September 30 2016	Three Months Ended September 30 2015	Nine Months Ended September 30 2016	Nine Months Ended September 30 2015
Revenue	\$ 8,733,335	\$ 5,966,046	\$ 23,161,300	\$ 21,771,341
Cost of sales	4,164,532	2,748,318	11,226,756	10,095,721
Gross Margin	4,568,803	3,217,728	11,934,544	11,675,620
	52.3%	53.9%	51.5%	53.6%
Operating expenses (notes 8 and 10):				
General and administrative	1,384,733	729,991	2,973,445	2,039,940
Engineering	243,598	232,773	821,854	615,371
Business development	232,227	119,024	691,010	408,346
Operating expenses	1,860,558	1,081,788	4,486,309	3,063,657
Net earnings before other earnings and tax	2,708,245	2,135,940	7,448,235	8,611,963
Other earnings (expenses):				
Interest and other earnings	74,214	23,934	117,004	68,528
Interest expense	(3,264)	(41)	(3,743)	(304)
Foreign exchange gain (loss)	167,321	483,402	(583,966)	1,435,527
	238,271	507,295	(470,705)	1,503,751
Net earnings before income tax	2,946,516	2,643,235	6,977,530	10,115,714
Income tax expense	(766,000)	(679,211)	(1,813,000)	(2,621,211)
Deferred income tax expense	-	-	-	-
Net earnings and total comprehensive income	\$ 2,180,516	1,964,024	\$ 5,164,530	7,494,503
Basic and diluted earnings (loss) per share				
Weighted average common shares used in computing	105,023,286	102,908,751	105,023,286	102,908,751
Diluted average common shares used in computing	113,263,292	112,312,871	113,263,292	112,312,871
Basic earnings per share	\$0.02	\$0.02	\$0.05	\$0.07
Diluted earnings per share	\$0.02	\$0.02	\$0.05	\$0.07

See accompanying notes to consolidated financial statements.

PHOTON CONTROL INC.

Consolidated Statements of Changes in Equity (Expressed in Canadian dollars) As at September 30, 2016 and 2015

For the nine months ending September 30, 2015

	Share Capital		Contributed Surplus and Deficit		
	Number of Shares	Amount	Contributed Surplus	Deficit	Total
Balance at December 31, 2014	102,185,518	\$ 27,911,549	\$ 3,216,511	\$ (9,479,105)	\$ 21,648,955
Stock based compensation to employees	-	-	374,321	-	374,321
Share issues	535,000	53,750	-	-	53,750
NCIB share buy backs	-	-	-	-	-
Total comprehensive income (loss)	-	-	-	2,720,407	2,720,407
Balance at March 31, 2015	102,720,518	\$ 27,965,299	\$ 3,590,832	\$ (6,758,698)	\$ 24,797,433
Stock based compensation to employees	-	-	79,444	-	79,444
Share issues (exercise of options)	347,000	34,699	-	-	34,699
NCIB share buy backs	-	-	-	-	-
Total comprehensive income (loss)	-	-	-	2,810,072	2,810,072
Balance at June 30, 2015	103,067,518	\$ 27,999,998	\$ 3,670,276	\$ (3,948,626)	\$ 27,721,648
Stock based compensation to employees	-	-	65,608	-	65,608
Share issues (exercise of share options)	872,500	87,252	-	-	87,252
NCIB share buy backs	-	-	-	-	-
Total comprehensive income (loss)	-	-	-	1,964,024	1,964,024
Balance at September 30, 2015	103,940,018	\$ 28,087,250	\$ 3,735,884	\$ (1,984,602)	\$ 29,838,532

For the nine months ending September 30, 2016

	Share Capital		Contributed Surplus and Deficit		
	Number of Shares	Amount	Contributed Surplus	Deficit	Total
Balance at December 31, 2015	103,971,518	\$ 28,217,623	\$ 3,694,121	\$ (274,686)	\$ 31,637,058
Stock based compensation to employees	-	-	102,274	-	102,274
Share issues	558,500	56,230	-	-	56,230
NCIB share buy backs	(130,000)	(91,516)	-	-	(91,516)
Total comprehensive income (loss)	-	-	-	1,586,899	1,586,899
Balance at March 31, 2016	104,400,018	\$ 28,182,337	\$ 3,796,395	\$ 1,312,213	\$ 33,290,945
Stock based compensation to employees	-	-	206,750	-	206,750
Share issues (exercise of options)	465,000	71,743	-	-	71,743
NCIB share buy backs	(189,500)	(136,125)	-	-	(136,125)
Total comprehensive income (loss)	-	-	-	1,397,114	1,397,114
Balance at June 30, 2016	104,675,518	\$ 28,117,955	\$ 4,003,145	\$ 2,709,327	\$ 34,830,427
Stock based compensation to employees	-	-	182,961	-	182,961
Share issues (exercise of share options)	3,310,000	823,600	-	-	823,600
NCIB share buy backs	-	-	-	-	-
Total comprehensive income (loss)	-	-	-	2,180,516	2,180,516
Balance at September 30, 2016	107,985,518	\$ 28,941,555	\$ 4,186,106	\$ 4,889,843	\$ 38,017,504

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

PHOTON CONTROL INC.

Consolidated Statement of Cash Flows

(Expressed in Canadian dollars)

For the nine months ended September 30, 2016 and 2015

As at September 30	2016	2015
Cash provided by (used in):		
Operations:		
Net earnings	\$ 5,164,530	\$ 7,494,503
Non-cash items:		
Depreciation of property, plant and equipment	110,695	56,814
Amortization expenses of intangibles	41,218	33,389
Stock-based compensation	491,985	519,373
Accretion income	8,829	(8,065)
Amortization on gain on sale to R&D	-	-
Inventory reserve provision	99,000	76,000
Allowance for doubtful accounts	98,937	-
Deferred tax	-	2,138,211
Changes in non-cash operating working capital:		
Trade accounts receivable and other	(1,708,304)	893,848
Inventory	(392,051)	(1,302,409)
Prepaid expenses and deposits	(328,905)	121,434
Accounts payable and accrued liabilities	618,823	679,402
Corporate tax payable	(437,000)	-
Due to/from related party	712,890	219,872
Misc receivable due from related party	-	-
Contingent liabilities	(28,037)	-
Deferred revenue	-	13,689
	4,452,610	10,936,061
Financing:		
Shares buy-back (Normal Course Issuer Bid)	(227,643)	-
Shares issue expenses (Normal Course Issue Bid)	-	-
Shares issue proceeds (exercise of options)	951,575	175,701
Proceeds from note receivable	6,699	23,701
	730,631	199,402
Investments:		
Restricted cash	-	-
Purchase of equipment	(258,885)	(188,124)
Purchase of intangible assets	(12,730)	(8,105)
Deferred development costs	-	-
	(271,615)	(196,229)
Increase (decrease) in cash and cash equivalents	4,911,626	10,939,234
Cash and cash equivalents, beginning of year	26,227,017	14,061,381
Cash and cash equivalents, end of year	31,138,643	25,000,615

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

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

(Expressed in Canadian dollars, unless specifically indicated otherwise)

For the nine months ended September 30, 2016 and 2015

1. Nature of business and continuing operations:

Photon Control Inc. (“Photon Control” or the “Company”) is a publicly-traded company listed on the TSX Venture Exchange (the “TSX-V”) and is incorporated under the laws of British Columbia, Canada. The Company’s head office is 200-8363 Lougheed Highway, Burnaby, British Columbia, Canada, V5A 1X3. The address of the registered office and records office is 19th Floor, 885 West Georgia Street, Vancouver, British Columbia, Canada, V6C 3H4.

The consolidated interim financial statements of the Company for the nine months ended September 30, 2016 comprise the Company and its (inactive) subsidiaries. The consolidated financial statements were authorized for issue by the Board of Directors on November 22, 2016.

Photon Control designs, manufactures and distributes a wide range of optical sensors and instruments to measure temperature, pressure, position, and flow. These products are used by original equipment manufacturers (OEM) as well as end-users in the Semiconductor, Oil and Gas, Power, Life Science, and Manufacturing industries. The Company’s common shares are listed on the TSX-V under the trading symbol PHO. In 2002, the Company changed its name from Coldswitch Technologies Inc. to Photon Control Inc.

2. Significant accounting policies:

(a) Basis of presentation and statement of compliance:

These condensed consolidated interim financial statements of the Company and its subsidiaries were prepared in compliance with the International Accounting Standard (IAS) 34 Interim Financial Reporting as issued by the International Accounting Standards Board (“IASB”). The condensed consolidated interim financial statements do not include all of the information for full annual financial statements.

These consolidated financial statements have been prepared on the historical cost basis except for certain financial assets and financial liabilities which are measured at fair market value. The consolidated financial statements are presented in Canadian (CAD) dollars which is the Company’s functional currency.

(b) Basis of consolidation:

The Company consolidates subsidiaries controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

2. Significant accounting policies (continued):

Inter-company balances and transactions, including any income and expenses arising from intercompany transactions, are eliminated in preparing the consolidated financial statements.

These consolidated financial statements include the accounts of the Company's wholly owned subsidiaries LAI Lightwave Aerospace Industries Ltd., CST Coldswitch Holdings Inc., The Lightswitch Company Inc., and Photon Control (Alberta) Inc., all of which are inactive.

(c) Cash and cash equivalents:

Cash and cash equivalents consist of highly liquid investments that are readily convertible to known amounts of cash. Short-term investments have maturity dates of nine months or less from the date of purchase, or they are redeemable prior to maturity.

(d) Inventory:

Inventory consists of optical, mechanical and electronic components and finished goods and is valued at the lower of cost or net realizable value. Cost is determined on a first in first out basis, and includes the cost of direct material, direct labour and other overhead costs. Labour costs are allocated to items based on actual labour rates. Fixed and variable overhead are allocated to production activities in converting materials to finished goods.

(e) Property and equipment:

Property and equipment are stated at cost. Depreciation is provided on the declining balance basis at the following annual rates:

Asset	Rate
Lab equipment	20%
Computers, office furniture and equipment	20%
Production equipment	30%
Leasehold improvements	Over the lesser of the initial term of the lease and the useful life of assets

(f) Intangible assets:

The costs of acquiring intangible assets, consisting of licenses, patents and trademarks, and software are capitalized. Costs are amortized over the lesser of the estimated useful life of the intangible asset or the license term.

(g) Revenue recognition:

Revenue from sales of products is recognized when goods are shipped and title passes, there is persuasive evidence of an arrangement, collection is probable and fees are fixed and determinable. Cash collected prior to revenue recognition criteria being met is recorded as deferred revenue on the consolidated statements of financial position.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

2. Significant accounting policies (continued):

(h) Research and development costs:

Research costs are expensed as incurred. Development costs are expensed as incurred unless all of the following can be demonstrated:

- The technical feasibility of completing the intangible asset so that it will be available for use or sale;
- The intention to complete the intangible asset and use or sell it;
- The ability to use or sell the intangible asset;
- How the intangible asset will generate probable future economic benefits;
- The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- The ability to measure reliably the expenditure attributable to the intangible asset during its development.

(i) Government assistance:

The Company makes periodic applications for financial assistance under available government incentive programs. Government assistance relating to capital expenditures is reflected as a reduction of the cost of such assets, while government assistance relating to current expenses is recorded as a reduction of such expenses.

The benefits of government assistance are recognized when there is reasonable assurance that they will be realized. Reasonable assurance is considered to have occurred when the relevant authorities have indicated that the Company's research and development activities qualify for government assistance. The Company did not receive any government assistance during the nine months ended September 30, 2016 nor for the nine months ended September 30, 2015.

(j) Earnings (loss) per share:

Basic earnings (loss) per share amounts are calculated by dividing net earnings (loss) by the weighted average number of common shares outstanding during the year. Diluted earnings per share amounts are computed similarly to basic earnings per share except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of additional options and warrants, if dilutive. The number of additional shares are calculated by assuming that outstanding stock options and warrants were exercised and that the proceeds from such exercises were used to acquire shares of common stock at the average market price during the year.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

2. Significant accounting policies (continued):

(k) Income taxes:

Tax expense comprises current and deferred tax. Tax is recognized in the consolidated statements of comprehensive income except to the extent it relates to items recognized directly in equity.

Current income tax

Current tax expense is based on the results for the period as adjusted for items that are not taxable or not deductible. Current tax is calculated using tax rates and laws that were substantively enacted at the end of the reporting period. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. Provisions are established where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred tax

Deferred taxes are the taxes expected to be payable or recoverable on differences between the carrying amounts of assets in the consolidated statements of financial position and their corresponding tax bases used in the computation of taxable profit, and are accounted for using the balance sheet asset and liability method. Deferred tax liabilities are generally recognized for all taxable temporary differences between the carrying amounts of assets and their corresponding tax bases. Deferred tax assets are recognized to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilized. Such assets and liabilities are not recognized if the temporary difference arises from the initial recognition of goodwill or from the initial recognition (other than in a business combination) of other assets in a transaction that affects neither the taxable profit nor the accounting profit.

(l) Share issue costs:

The costs of issuing common shares are applied to reduce the stated value of such shares.

(m) Translation of foreign currencies:

Monetary items denominated in foreign currencies are translated to Canadian dollars at exchange rates in effect at the Statement of Financial Position dates and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenue and expenses are translated at rates in effect at the time of the transactions. Foreign exchange gains and losses are included in earnings.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

2. Significant accounting policies (continued):

(n) Stock-based compensation plans:

The Company has a stock-based compensation plan, which is described in Note 7(c). The fair value of the services rendered is determined indirectly by reference to the fair value of the equity instruments granted. Compensation cost attributable to options granted to employees and directors is measured at the fair value at the grant date using the Black-Scholes option pricing model. Compensation expense is recognized over the vesting period of the underlying option. Any consideration paid by employees on exercise of stock options or purchase of stock is credited to share capital. No compensation cost is recognized for options that employees forfeit if they fail to satisfy the service requirement for vesting. Compensation expense is recognized for stock-based payments to non-employees using the fair value of the goods or services received, unless the fair value of the equity instruments granted is more reliably determinable.

(o) Warranty provision:

The Company accrues for the estimated obligations under warranty provisions at the time sales are recognized and any changes in estimates are recognized prospectively. The Company provides its customers with a limited right of return for defective products. All warranty returns must be authorized by the Company prior to acceptance.

(p) Financial instruments:

The Company has classified its financial instruments as follows:

- Cash and cash equivalents and bank indebtedness, if any, as “held-for-trading”.
- Derivatives, if any, as “held-for-trading”.
- Trade accounts receivable, the note receivable and amounts due from related parties are classified as “loans and receivables”.
- Accounts payable and accrued liabilities, amounts due to related parties are classified as “other financial liabilities”.

All financial instruments are initially recognized at fair value and are subsequently accounted for based on their classification. The fair value of a financial instrument on initial recognition is the transaction price, which is the fair value of the consideration given or received.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

2. Significant accounting policies (continued):

Subsequent to initial recognition, financial assets and liabilities classified as held-for-trading are measured at fair value with changes in fair value recorded in the consolidated statements of comprehensive income. Financial assets classified as "loans and receivables" and "other financial liabilities" are carried at amortized cost using the effective interest rate method. The fair values are based on quoted market bid process if available; otherwise fair value is obtained using discounted cash flow analysis. Transaction costs that are directly attributable to the issuance of financial assets or liabilities are accounted for as part of the carrying value at inception, and are recognized over the term of the assets or liabilities using the effective interest method.

The Company assesses at the end of each reporting period whether there is objective evidence that financial assets are impaired. A financial asset is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset that has a negative impact on the estimated future cash flows of the financial asset that can be reliably measured. When there is objective evidence that an impairment loss on a financial asset measured at amortized cost has been incurred, an impairment loss is recognized in net earnings for the period measured as the difference between the financial asset's (a) fair value less costs to sell, and (b) value in use.

(q) Impairment of property, equipment, intangibles and internally generated intangible assets:

At each date of the consolidated statement of financial position, the Company's carrying amounts of its assets are reviewed to determine whether there are any indications of impairment. If such indication exists, the recoverable amount of the assets is estimated using the higher of (a) fair value less costs to sell, and (b) value in use.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount is less than its carrying amount, the carrying amount is reduced to its recoverable amount and the impairment loss is recognized in profit or loss for the period. When there are indicators that the conditions giving rise to the impairment previously recognized have reversed, then the reversal of the impairment loss is reversed in that period.

(r) Use of estimates

The preparation of these consolidated financial statements in conformity with IFRS requires management to make sufficient judgements, estimates and assumptions that affect the reported amounts of assets and liabilities, application of accounting policies and the reporting of assets and liabilities at the dates of the consolidated financial statements and the reported revenue and expenses during the years.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

2. Significant accounting policies (continued):

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which estimates are revised and any future periods affected. There have been no changes made to the methodology to determine critical accounting estimates during the last two fiscal years.

Significant items subject to such assumptions and estimation uncertainties that have a significant risk of a material adjustment are as follows:

- i) Stock based compensation comprises compensation expense related to the granting of stock options. The Company values stock options using a fair value-based method of accounting. The fair value of stock options is estimated at the grant or issue date using the Black-Scholes option pricing model. The Black-Scholes option pricing model requires the input of a number of assumptions, including expected dividend yield, expected stock price volatility, life of the options, forfeiture rate, and risk-free interest rates.

These assumptions are determined using management's best estimates and involve inherent uncertainties relating to market conditions, forfeitures and exercise which are outside of the control of the Company. Such assumptions are reviewed quarterly and have a significant impact on the estimates of fair value produced by the Black-Scholes option pricing model.

- ii) The Company makes estimates related to the recovery of deferred development costs based on the expectation and assumption of realizing revenues from future commercial agreements that it anticipates will develop with companies for whom these projects have been untaken. Changes in these expectations and assumptions could result in a change in the recoverable amount calculated.
- iii) The Company makes estimates related to the useful lives of property and equipment, patents, and intangible assets and related amortization. The Company also periodically assesses the recoverability of long lived assets. The recoverability analysis requires the Company to make assumptions about future operations. Changes to one or more assumptions would result in a change in the recoverable amount calculated and/or depreciation expensed.
- iv) The Company maintains an allowance for doubtful accounts for estimated losses that may occur if parties are unable to pay balances owing to the Company. This allowance is determined based on a review of specific parties' historical experience and economic circumstances. Non-Canadian export trade customers are covered by Export Development Canada (EDC) receivables insurance up to a maximum of USD \$1,500,000. Consequently, the estimates of allowance are primarily based on Canadian customers, none of whom are not covered by EDC insurance, but also include estimates for any EDC receivables insurance deductible amounts.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

2. Significant accounting policies (continued):

- v) Valuation adjustments for inventory are comprised of the impairments or recoveries recorded against inventories. The Company records valuation adjustments for inventory by comparing the inventory cost to its net realizable value. This process requires the use of estimates and assumptions related to future market demand, costs and prices. Such assumptions are reviewed quarterly and have a significant impact on the valuation adjustments for inventory.
 - vi) The Company makes estimates related to warranty provision. This provision is based on a periodic review of historical experience of warranty claims.
 - vii) Deferred income tax assets are recognized for all deductible temporary differences, carry-forward of unused tax assets and unused tax losses, to the extent that probable that future taxable profit will be available against which the deductible temporary differences and carry-forward of unused tax assets and unused tax losses can be utilized. In addition, the valuation of tax credits receivable requires management to make judgements on the amount and timing of recovery.
- (s) Accounting Judgments:

In applying the Company's accounting policies, management has made certain judgments that may have a significant effect on the amounts recognized in the consolidated financial statements. Such judgments include the determination of the functional currency.

In determining the Company's functional currency, it periodically reviews its primary and secondary indicators as stipulated under IAS 21, "The Effects of Changes in Foreign Exchange Rates" to assess the Company's primary economic environment in which the Company operates. The Company analyzes the currency that mainly influences revenues, labour, material and other costs of providing goods or services which is often the currency in which such costs are denominated and settled. The Company also analyzes secondary indicators such as the currency in which funds from financing activities such as debt and equity issuances are generated and the currency in which receipts from operating activities are retained. Determining the Company's predominant economic environment requires significant judgment.

These consolidated financial statements, in management's opinion, have been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized above.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

3. Recently adopted and future accounting pronouncements:

The following accounting pronouncements became effective for the Company for the current fiscal year ending December 31, 2015 and were adopted as at January 1, 2015:

(a) The IASB intends to make amendments to IFRS 8, Operating segments:

The amendments to IFRS 8, issued by the International Accounting Standards Board (IASB) in December 2013, incorporated into Part I of the CPA Canada Handbook - Accounting by the Accounting Standards Board (AcSB) in March 2014, require an entity to disclose the judgments made by management in applying the aggregation criteria for reportable segments. The amendments will only affect disclosure and are effective for annual periods beginning on or after July 1, 2014. The Company is currently evaluating the impact the final standard is expected to have on its consolidated financial statements.

(b) The IASB intends to make amendments to IFRS 11, Joint Arrangements:

In May 2014, the IASB issued amendments to this Standard, incorporated into the Handbook by the AcSB in July 2014, to clarify that the acquirer of an interest in a joint operation in which the activity constitutes a business, as defined in IFRS 3 Business Combinations, is required to apply all of the principles on business combinations accounting in IFRS 3 and other IFRSs with the exception of those principles that conflict with the guidance in IFRS 11. The amendments apply to the acquisition of an interest in a joint operation on its formation, unless the formation of the joint operation coincides with the formation of the business, and the acquisition of additional interests in the same joint operation. The Company is currently evaluating the impact the final standard is expected to have on its consolidated financial statements.

(c) The IASB intends to make amendments to IAS 24, Related Party Disclosures:

The amendments to IAS 24, issued by the International Accounting Standards Board (IASB) in December 2013, incorporated into Part I of the CPA Canada Handbook – Accounting by the Accounting Standards Board (AcSB) in March 2014, clarify that a management entity, or any member of a group of which it is a part, that provides key management services to a reporting entity, or its parent, is a related party of the reporting entity. The amendments also require an entity to disclose amounts incurred for key management personnel services provided by a separate management entity. This replaces the more detailed disclosure by category required for other key management personnel compensation. The amendments will only affect disclosure and are effective for annual periods beginning on or after July 1, 2014. The Company is currently evaluating the impact the final standard is expected to have on its consolidated financial statements.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the nine months ended September 30, 2016 and 2015

3. Recently adopted and future account pronouncements (continued):

The Company has reviewed new and revised accounting pronouncements that have been issued but are not yet effective and is assessing the impact of these new standards and amendments but they are not expected to have a material impact on the Company:

(d) The IASB intends to implement IFRS 9, Financial Instruments:

Recognition and Measurement in its entirety with IFRS 9, Financial Instruments (“IFRS 9”) which is intended to reduce the complexity in the classification and measurement of financial instruments. At present, the current version of IFRS 9 does not include a mandatory effective date. However, IFRS 9 is available for early application. An effective date will be added when all phases of the project are completed. The Company is currently evaluating the impact the final standard is expected to have on its consolidated financial statements.

(e) The IASB intends to implement IFRS 15, Revenue from Contracts with Customers:

In May 2014, the International Accounting Standard Board (IASB) issued a new International Financial Reporting Standard (IFRS) on the recognition of revenue from contracts with customers. IFRS 15 specifies how and when entities recognize revenue, as well as requires more detailed and relevant disclosures. IFRS 15 supersedes IAS 11 Construction Contracts.

IAS 18 Revenue, IFRIC 13 Customer Loyalty Programmes, IFRIC 15 Agreements for the Construction of Real Estate, IFRIC 18 Transfers of Assets from Customers and SIC-31.

Revenue – Barter Transactions Involving Advertising Services. The Section provides a single, principles based five-step model to be applied to all contracts with customers, with certain exceptions. The five steps are:

- i) Identify the contract(s) with the customer.
- ii) Identify the performance obligation(s) in the contract.
- iii) Determine the transaction price.
- iv) Allocate the transaction price to each performance obligation in the contract.
- v) Recognize revenue when (or as) the entity satisfies a performance obligation.

The standard is effective for annual periods beginning on or after January 1, 2017. Earlier application is permitted. The Company is currently evaluating the impact the final standard is expected to have on its consolidated financial statements.

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4. Inventory:

As at September 30	2016	2015
Raw materials	\$ 1,421,212	\$ 1,447,078
Work in process	753,902	633,695
Finished goods	751,946	936,970
	<hr/>	<hr/>
	\$ 2,927,060	\$ 3,017,743

For the nine months ended September 30, 2016, inventory recognized as an expense in cost of sales amounted to \$6,982,997 (September 30, 2015 - \$6,113,585). Included in the above amount for the nine months ending September 30, 2016 were inventory write downs of \$81,000 (nine months ending September 30, 2015 – \$81,000). There were no reversals of previously recorded inventory write downs for 2015 (September 30, 2015 - Nil).

As of September 30, 2016, the Company anticipates the net inventory will be realized within one year.

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5. Property and equipment:

	Laboratory equipment	Computers, office furniture and equipment	Production equipment	Leasehold improvements	Total
Asset Cost					
Balance January 1, 2015	\$ 346,446	323,050	454,642	390,875	1,515,013
Additions	-	45,447	242,908	6,747	295,102
Balance December 31, 2015	346,446	368,497	697,550	397,622	1,810,115
Additions	-	55,110	201,145	2,630	258,885
Disposals	-	-	-	-	-
Balance September 30, 2016	\$ 346,446	423,607	898,695	400,252	2,069,000

Accumulated Depreciation					
Balance January 1, 2015	\$ 279,647	257,755	331,895	379,186	1,248,483
Depreciation for year	14,856	16,724	47,553	3,008	82,141
Balance December 31, 2015	294,503	274,479	379,448	382,194	1,330,624
Depreciation for year	7,020	16,272	84,914	2,489	110,695
Disposals	-	-	-	-	-
Balance September 30, 2016	\$ 301,523	290,751	464,362	384,683	1,441,319

Carrying Amounts					
At January 1, 2014	\$ 66,799	65,295	122,747	11,689	266,530
At December 31, 2015	\$ 51,943	94,018	318,102	15,428	479,491
At September 30, 2016	\$ 44,923	132,856	434,333	15,569	627,681

PHOTON CONTROL INC.

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6. Intangible assets:

	Patents	Trademarks	Computer software	Computer system (SW)	Total
Asset Cost					
Balance January 1, 2015	\$ 378,053	28,602	94,683	191,362	692,700
Additions	-	-	26,083	-	26,083
Balance December 31, 2015	378,053	28,602	120,766	191,362	718,783
Additions	-	-	12,730	-	12,730
Balance September 30, 2016	\$ 378,053	28,602	133,496	191,362	731,513
Accumulated Amortization					
Balance January 1, 2015	317,133	27,577	94,683	109,383	548,776
Amortization for year	19,627	1,025	3,650	23,149	47,451
Balance December 31, 2015	\$ 336,760	28,602	98,333	132,532	596,227
Amortization for year	7,740	-	20,239	13,239	41,218
Balance September 30, 2016	\$ 344,500	28,602	118,572	145,771	637,445
Carrying Amounts					
At January 1, 2014	\$ 60,920	1,025	-	81,979	143,924
At December 31, 2015	\$ 41,293	-	22,433	58,830	122,556
At September 30, 2016	\$ 33,553	-	14,924	45,591	94,068

PHOTON CONTROL INC.

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7. Share capital:

(a) Authorized:

Unlimited number of common shares without par value

(b) Issued and outstanding:

Common shares:

	Number of shares	Stated values
Issued and outstanding as at December 31, 2014	102,185,518	\$ 27,911,549
Shares issued in 2015	1,786,000	306,074
Issued and outstanding as at December 31, 2015	103,971,518	\$ 28,217,623
Shares issued in 2016 (exercise of options)	3,310,000	951,573
Share buy-back (Normal Course Issuer Bid)	(319,500)	(227,641)
Issued and outstanding as at September 30, 2016	107,985,518	\$ 28,941,555

Note: The Company was authorized on December 24, 2015 to undertake a Normal Course Issuer Bid (NCIB) in compliance with the requirements of the TSX-V allowing it to repurchase, for cancelation, up to 5,000,000 shares in its own stock. The NCIB period covers January 4, 2016 to January 3, 2017.

Contributed Surplus:

	Amount
Balance, December 31, 2014	\$ 3,216,511
Stock-based compensation to employees in 2015	477,610
Shares issued in 2015 (exercise of options)	Nil
Balance, December 31, 2015	\$ 3,694,121
Stock-based compensation to employees in 2016	491,985
Shares issued in 2016 (exercise of options)	Nil
NCIB share buy back in 2016	Nil
Balance, September 30, 2016	\$ 4,186,106

PHOTON CONTROL INC.

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

(c) Stock options:

Stock option transactions are summarized as follows:

	Number of Share Options	Weighted average exercise price
Outstanding, December 31, 2014	10,184,000	\$ 0.240
Granted	30,000	\$ 0.490
Granted	20,000	\$ 0.620
Granted	140,000	\$ 0.690
Granted	10,000	\$ 0.660
Granted	30,000	\$ 0.700
Forfeited	(25,000)	\$ 0.100
Expired	(125,000)	\$ 0.100
Exercised	(1,756,000)	\$ 0.100
Exercised	(10,000)	\$ 0.105
Exercised	(10,000)	\$ 0.110
Exercised	(10,000)	\$ 0.115
Outstanding, December 31, 2015	8,478,000	\$ 0.284
Granted	10,000	\$ 0.650
Granted	270,000	\$ 0.670
Granted	10,000	\$ 0.690
Granted	10,000	\$ 0.700
Granted	1,727,000	\$ 0.710
Granted	10,000	\$ 0.720
Granted	20,000	\$ 0.730
Granted	30,000	\$ 0.740
Granted	10,000	\$ 0.760
Granted	10,000	\$ 0.840
Expired	(10,000)	\$ 0.290
Expired	(10,000)	\$ 0.690
Forfeited	(5,000)	\$ 0.200
Forfeited	(10,000)	\$ 0.690
Forfeited	(510,000)	\$ 0.710
Exercised	(3,818,000)	\$ 0.100
Exercised	(10,000)	\$ 0.110
Exercised	(493,000)	\$ 0.150
Exercised	(5,000)	\$ 0.200
Exercised	(5,000)	\$ 0.300
Exercised	(2,500)	\$ 0.490
Exercised		
Outstanding, September 30, 2016	5,706,500	\$ 0.534

310,000 stock options were granted during the three months ended September 30, 2016 (110,000 options granted for the three months ended September 30, 2015).

PHOTON CONTROL INC.

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

(c) Stock options (continued):

The number of options reserved for issuance under the Company's stock option plan is equal to 10% of the issued and outstanding shares in the Company. Accordingly, as at September 30, 2016, the Company has reserved 10,798,552 options (September 30, 2015 - 10,306,752 options) for issuance under the Company's stock option plan. The stock option plan provides that options may be granted with an exercise price of not less than the market price of the Company's shares on the grant date less applicable discounts permitted by the TSX-V. The stock option plan also provides that the term of the options shall not exceed five years.

The following table summarizes the stock options outstanding at September 30, 2016:

Exercise price	Options outstanding			Options exercisable	
	Number of options	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
\$0.100	670,000	0.97	\$ 0.100	665,000	\$ 0.100
\$0.150	1,157,000	2.00	\$ 0.150	1,157,000	\$ 0.150
\$0.165	10,000	2.02	\$ 0.165	5,000	\$ 0.165
\$0.295	10,000	2.27	\$ 0.295	5,000	\$ 0.295
\$0.300	15,000	2.38	\$ 0.300	7,500	\$ 0.300
\$0.310	10,000	2.32	\$ 0.310	5,000	\$ 0.310
\$0.320	10,000	2.50	\$ 0.320	5,000	\$ 0.320
\$0.425	20,000	2.94	\$ 0.425	5,000	\$ 0.425
\$0.490	17,500	3.36	\$ 0.490	4,375	\$ 0.490
\$0.500	2,020,000	2.98	\$ 0.500	2,020,000	\$ 0.500
\$0.620	10,000	3.63	\$ 0.620	2,500	\$ 0.620
\$0.650	10,000	4.28	\$ 0.650	-	\$ 0.650
\$0.660	10,000	4.15	\$ 0.660	-	\$ 0.660
\$0.670	270,000	4.81	\$ 0.670	67,500	\$ 0.670
\$0.690	130,000	3.99	\$ 0.690	30,000	\$ 0.690
\$0.700	40,000	4.36	\$ 0.700	-	\$ 0.700
\$0.710	1,217,000	4.59	\$ 0.710	-	\$ 0.710
\$0.720	10,000	4.45	\$ 0.720	-	\$ 0.720
\$0.730	20,000	4.55	\$ 0.730	-	\$ 0.730
\$0.740	30,000	4.67	\$ 0.740	-	\$ 0.740
\$0.760	10,000	4.87	\$ 0.760	-	\$ 0.760
\$0.840	10,000	4.70	\$ 0.840	-	\$ 0.840
	5,706,500	3.03	\$ 0.441	3,978,875	\$ 0.334

The options outstanding as at September 30, 2016 expire between September 18, 2017 and September 12, 2021.

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

The fair value of options granted was estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2016	2015
Expected option lives	5 years	5 years
Risk-free interest rate	0.62% to 1.90%	.69% to 2.71%
Dividend yield	0%	0%
Volatility	95% to 208%	96% to 309%

During the nine months ended September 30, 2016, the Company recorded \$491,985 (2015 - \$453,765) of compensation expense representing the fair value of the options and shares vesting during the nine months with a corresponding increase to contributed surplus.

(d) Restricted Share Units:

In Q1 2016, the Board of Directors of the Company adopted a new restricted share unit plan ("RSU Plan") for the Company, subject to applicable shareholder and regulatory approvals which have been obtained. A maximum of 1,000,000 common shares of the Company may be issued in respect of restricted share units ("RSUs") granted under the RSU Plan subject to any performance and vesting conditions determined by the Board of Directors of the Company, provided that the number of common shares reserved under the RSU Plan and stock options and any other stock incentives granted by the Company may not exceed 10% of the issued and outstanding common shares of the Company from time to time.

In May 2016, the Company granted to directors of the Company RSUs under the RSU Plan in respect of a net aggregate (after cancelations) of 645,000 common shares of the Company with one-third of the RSUs vesting on the date of grant and a further one-third of the RSUs vesting on each of the first and second anniversaries of the date of grant. In Q3 2016, an additional 229,000 RSUs were been granted to new directors and officer but 172,000 lapsed in Q3 2016.

The following table summarizes the Restricted Share Units (RSU) outstanding at September 30, 2016:

Exercise price	Options outstanding			Options exercisable	
	Number of options	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of RSU exercisable	Weighted average exercise price
\$0.67	129,000	1.80	\$ 0.670	43,000	\$ 0.670
\$0.71	473,000	1.58	\$ 0.710	215,000	\$ 0.710
\$0.75	100,000	0.75	\$ 0.750	50,000	\$ 0.750
Total	702,000	1.57	\$ 0.710	308,000	\$ 0.710

PHOTON CONTROL INC.

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

(e) Net earnings (loss) per share:

The weighted average number of shares outstanding as at September 30, 2016 of 105,023,286 (September 30, 2015 – 102,908,751) were used in the calculation of basic earnings per share for the nine months ended September 30, 2016 (September 30, 2015 - 112,312,871).

8. Related party balances and transactions:

(a) Related company balances and transactions:

During Q3 2016, the Company eliminated all non-arm's length relationships - specifically Photon Control R&D Ltd. and DCD Management Ltd. In future quarterly financial statements, the related party transactions will be nil for the current quarter.

All transactions with related parties have been translated in the normal course of operations and have been measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. Related party transactions include transactions with Photon Control R&D Ltd. and DCD Management Ltd. Photon Control R&D Ltd. commenced providing engineering consulting and research and development services to the Company on October 1, 2008 and, as a result, the Company has reduced its internal research and development operations. DCD Management Ltd. provides financial, payroll and IT services. The Company subleases space to Photon Control R&D Ltd. and DCD Management Ltd. at the same facility and charges both for premises and related expenses to recover the Company's costs. Amounts outstanding with DCD Management Ltd. are non-interest bearing, unsecured and due on demand. Amounts outstanding with Photon Control R&D Ltd. are unsecured and due on demand but, as of Q3 2014, outstanding balances were changed to interest bearing at prime plus 1%. These accounts are active and payments are received on a monthly basis, and the balance is paid out at least twice during the year.

Effective 2013, the Company signed a new engineering support standby fee with Photon Control R&D Ltd. of \$45,000 per month to ensure prompt technical responses to customer requests, support for OEM and other customers, development of new products and engineering design, and to maintain technical competitiveness while exploring new markets

On June 3, 2016, the sum of \$4,500,000 was transferred to Photon Control R&D Ltd. and was originally intended to be a short term loan. However, the transaction had not been approved by the Board of Directors prior to the transfer of funds and thus was a breach of corporate governance as well as regulatory requirements. The \$4,500,000 was returned to Photon Control Inc. in full on July 25, 2016 plus \$55,748 interest.

8. Related party balances and transactions (continued):

PHOTON CONTROL INC.

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During 2009, the Company finalized and amended the terms of its agreement to transfer its R&D workforce to Photon Control R&D Ltd. Under the finalized terms, Photon Control R&D Ltd. issued a \$315,000 promissory note to the Company as consideration for the transfer. The promissory note bears a coupon rate of 3% per annum, is repayable in equal monthly instalments of \$3,089 beginning April 1, 2010 and matures March 1, 2020.

The following represents those applicable related party transactions to be recognized during the Q3 2016 period.

As at September 30	2016	2015
Statement of Financial Position		
Accounts receivable due from related party	\$ 105,610	\$ 166,627
Miscellaneous due from related party	-	-
Note receivable	78,023	98,761
Accounts payable and accrued liabilities	825,022	194,935
Statement of Comprehensive Income		
Charges to:		
Revenue from sales of products and services to Photon R&D	\$ 508,314	\$ 103,990
Payroll reimbursement re: Photon Control R&D Ltd.	905,998	1,071,324
Recovery of premises and other related expenses (Re: DCD Management Ltd. and Photon Control R&D Ltd.)	261,284	231,043
Intercompany interest	-	2,058
Charges from:		
Products & services charged by Photon Control R&D Ltd.	\$ 101,780	\$ 155,591
Engineering & R&D services charged by Photon Control R&D	748,496	561,209
Royalty expenses charged by Photon Control R&D Ltd.	1,645,852	1,451,282
Intercompany interest charged by Photon Control R&D Ltd.	1,585	263
Management services expenses charged by DCD Mgmt. Ltd.	\$ 53,039	\$ 204,298

In connection with the litigation between the parties as described in note 16, the Company has stopped making certain payments related to the R&D agreements. The amounts potentially due under these agreements are being recorded as expenses in the Accounts payable and accrued liabilities, and are reflected in the accounts payable balance above in note 8(a).

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8. Related party balances and transactions (continued):

The promissory note receivable is being accreted up to its face value of \$315,000 by the effective interest method. As at September 30, 2016, \$48,077 (2015 - \$36,812) to date in accretion was recognized in interest income.

As at September 30	2016	2015
Promissory note receivable – face value	\$ 315,000	\$315,000
Less: discount	(97,513)	(97,513)
	217,487	217,487
Accretion	51,020	39,501
Principal repayment	(190,484)	(158,227)
Carrying amount	78,023	98,761
Current portion	(18,566)	(20,422)
Long-term portion	\$ 59,457	\$ 78,339

(b) Compensation of key management personnel:

The Company's key management personnel have authority and responsibility for overseeing, planning, directing and controlling the activities of the Company and consist of the Company's Board of Directors and the Company's Executive Leadership Team.

Total compensation expense for key management personnel and the composition thereof, for the nine months ended September 30, 2016 is:

	2016	2015
Short term benefits including acting CEO consulting	\$ 358,500	\$ 513,077
Share-based compensation	74,225	199,754
Carrying Amount	\$ 432,725	\$ 712,831

A portion of the short term benefits relates to expected bonuses (if applicable) that are to be paid subsequent to year end and subject to final determination by Board of Directors.

As at September 30, 2016, no bonus is included in the above nor is any expected to be paid subsequent to year end.

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9. Commitments and contingencies:

(a) Leases:

As at September 30, 2016, the Company has entered into premises leases requiring the following future minimum lease payments and related costs (applicable sales taxes extra) as follows:

2016	\$	207,613
2017		284,802
2018		284,802
2019		284,802
2020		284,802
2021		284,802
2022		284,802
2023		284,802
2024		284,802
	\$	2,486,029

For the nine months ended September 30, 2016, lease payments and related costs recognized as an expense amounted to \$662,839 (2015 - \$589,031).

The above amounts do not include any offset payments for subleases to Photon Control R&D Ltd. and DCD Management Ltd. which sublease portions of Photon Control Inc.'s facility. Future minimum sublease payments expected to be received by Photon Control Inc. under non-cancellable subleases are as follows:

2016	\$	62,007
	\$	62,007

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10. Supplementary information:

As at September 30	2016	2015
General and administrative:		
Salaries and consulting fees	\$ 982,201	\$ 894,933
Stock option compensation expense	491,985	519,372
Professional and legal fees	1,040,488	264,524
Depreciation and amortization	52,240	32,073
Other expenses	406,531	329,038
	<u>\$ 2,973,445</u>	<u>\$ 2,039,940</u>
Engineering expenses:		
Engineering support and consulting fees	\$ 748,496	\$ 561,209
Depreciation and amortization	7,740	14,464
Other expenses	65,618	39,698
	<u>\$ 821,854</u>	<u>\$ 615,371</u>
Business development and marketing:		
Salaries and consulting fees	\$ 533,876	\$ 335,086
Depreciation and amortization	-	1,025
Other expenses	157,134	72,235
	<u>\$ 691,010</u>	<u>\$ 408,346</u>

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11. Financial instruments:

Fair Value of Financial Assets and Liabilities:

The categories of the fair value hierarchy that reflect the significance of inputs used in making fair value measurements are as follows:

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – inputs other than quoted market prices included in Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices); and

Level 3 – inputs for the asset or liability that are not based on observable market data.

At September 30, 2016, the levels in the fair value hierarchy into which the Company's financial assets and liabilities are measured and recognized on the Consolidated Statement of Financial Position at fair value on a recurring basis are categorized as follows:

	Category	At September 30, 2016	At September 30, 2015
Cash and cash equivalents	Level 1	\$31,138,643	\$ 25,000,615
Total		\$31,138,643	\$ 25,000,615

The Company's policy for determining when a transfer occurs between levels in the fair value hierarchy is to assess the impact at the date of the event or the change in circumstances that could result in a transfer.

Cash and cash equivalents are classified as held for trading and are recorded at fair value in the consolidated statement of financial position. The Company had no other financial instruments recorded at fair value as at September 30, 2016, nor as at September 30, 2015.

Periodically, derivative financial instruments are used to manage the Company's exposure to foreign exchange market risks, generally through forward foreign exchange contracts. The fair values of forward contracts are calculated using discounted contractual cash flows based on quoted forward curves and discount rates incorporating US and Canadian interest rates. Forward foreign exchange contracts were not utilized during the 2015 – 2016 year.

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11. Financial instruments (continued):

The note receivable from related party is measured at amortized cost. Its market value was determined at inception based upon discounting contractual cash flows at estimated market discount rates considering the credit risk of the counterparty. The estimated market value as at September 30, 2016 is estimated to approximate its carrying value.

The fair value of the Company's cash and cash equivalents, trade accounts receivable and other amounts due under credit facility, amounts due to and from related parties, accounts payable and accrued liabilities approximate their respective carrying amounts due to their short maturities or are discounted at market interest rates.

Risk Management:

The Company manages its exposure to financial risk, including credit and interest rate risk, liquidity risk, and foreign exchange risk. The Company's Board of Directors oversees management's risk management practices. In Q3 2016, the Board of Directors approved a new Investment Policy in order to strengthening oversight and minimise risk.

The following describes the types of risks that the Company is exposed to and its objectives and policies for managing those risk exposures.

(a) Credit and interest rate risk:

The Company is exposed to credit risk associated with its trade accounts receivable and related party receivables. Credit risk is minimized substantially by ensuring the credit worthiness of the entities with which it carries on business. In November 2009, the Company entered into an agreement with Export Development Canada to insure its non-Canadian accounts receivable up to a maximum of USD \$1,500,000. As at September 30, 2016 the maximum credit risk, which is the total of its uninsured trade receivables (primarily Canadian based customers and intercompany), was \$429,279 or 9% (September 30, 2015 - \$290,438 or 9%) of the total outstanding accounts receivable balances.

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11. Financial instruments (continued):

The following table provides information regarding the aged trade receivables as at September 30, 2016:

Current	31-60 days	61-90 days	91 days +
63%	29%	2%	6%

The following table provides information regarding the aged trade receivables as at September 30, 2015:

Current	31-60 days	61-90 days	91 days +
57%	42%	1%	0%

The Company holds its cash and cash equivalents at a major Canadian banking institution. As at September 30, 2016, the Company was not exposed to significant credit or interest rate risk.

Allowance for Doubtful Accounts

At each period end, the Company reviews the collectability of outstanding receivables. The specific accounts are only written off once all the collection avenues have been explored or when bankruptcy has occurred. The following is a reconciliation of the allowance account.

Reconciliation of the allowance for doubtful accounts as of September 30	2016	2015
Balance, beginning of the year	\$ 155,000	\$ 51,774
(Write-offs) recovery of specific accounts	1,495	-
Change in provision	9,000	13,692
Balance as at September 30	\$ 165,495	\$ 65,466

PHOTON CONTROL INC.

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11. Financial instruments (continued):

The following table identifies the percentage of trade accounts receivable from individual customers comprising 10% or more of the Company's trade receivables:

September 30	2016	2015
Customer A	48%	59%
Customer B	14%	11%
Customer C	5%	9%
Customer D	10%	8%
Customer E	7%	1%

Note: Customer D is now buying direct from Photon Control rather than through Customer C.

(b) Market, interest and foreign exchange risk:

Market risk is the risk that changes in market prices such as foreign exchange rates and interest rates will affect the Company's net earnings or the values of financial instruments. The Company is exposed to interest rate risk with regard to the cash, cash equivalents and amounts due under credit facility and its related party note receivable. The majority of the Company's sales revenues and trade receivables are denominated in United States dollars. As such, the Company may be subject to material, realized and unrealized exchange gains or losses resulting from above average changes in exchange rates between the Canadian and the United States dollar. Beginning in the fourth quarter 2013, the Company started to utilize forward exchange contracts to mitigate any of the risks as mentioned above. As of September 19, 2014, all of the remaining forward exchange contracts have expired thus there are no forward exchange contracts in effect as at September 30, 2016

The contracts required the sale of an agreed upon amount of US dollars at specified future dates at forward exchange rates. These financial instruments were entered into solely to mitigate foreign exchange risk and were not used for speculation. These derivatives were not designated as a hedge for accounting purposes. The Company does not expect any credit losses in the event of non-performance by the counterparty as the counterparty is a well-established brokerage firm. As at September 30, 2016, the impact of any additional foreign exchange expenses of these contracts has been recognized.

The following table lists the United States dollar balances of monetary items denominated in United States dollars as at September 30:

Amounts denominated in U.S. dollars as at September 30	2016	2015
Cash	\$ 8,544,622	\$ 518,436
Trade accounts receivable	3,083,643	2,265,961
Trade accounts payable	265,243	196,325

The estimated impact on net earnings at September 30, 2016 with a +/- 10% change in foreign exchange rates is CAD \$1,490,488 (September 30, 2015 – CAD \$345,378).

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11. Financial instruments (continued):

The above sensitivity demonstrates the effect of a change in foreign exchange rates in isolation. In reality, there may be other contributing factors that will materially alter the estimated outcome. Furthermore, the financial position of the Company may vary at the time that a change in foreign currency exchange rates occurs, again, causing the impact on the Company's results to differ materially from the estimated outcome shown above.

(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 ability to do this relies on the Company being able to successfully rely on external financing as well as the timely collection of its outstanding trade accounts receivable. As at September 30, 2016, the Company's accounts trade payable and accrued liabilities were \$1,551,945 (September 30, 2015 - \$1,124,672) which fall due for payment within twelve months of the balance sheet date. As at September 30, 2016, the Company had access to a credit facility of \$1,000,000. This credit facility currently remains unutilized (also unutilized as at September 30, 2015).

Significant cash commitments in years subsequent to September 30, 2016 are as follows:

	1 year	2 year	3 year	4 year	5 year	Total
Accounts trade payable and accrued liabilities	\$ 1,834,009	-	-	-	-	\$ 1,834,009
Corporate tax payable	173,462	-	-	-	-	173,462
Due to related company (Disputed)	825,022	-	-	-	-	825,022
Standby engineering (Disputed)	135,000	-	-	-	-	135,000
Lease obligation	207,613	284,802	284,802	284,802	284,802	1,346,821

The standby engineering charge is subject to review (annually) and possible change in the future.

In addition, there is a significant cash commitment with regard to royalties which is based on a variable percentage of revenue for applicable products. Although no specific amounts can be determined for the future, royalties were \$1,656,852 for the nine months ended September 30, 2016 (September 30, 2015 - \$1,451,282).

12. Capital disclosure:

The Company's objectives when managing capital are:

- To maintain its ability to continue as a going concern.
- To provide adequate working capital.
- To maintain cash on hand in highly liquid and highly rated financial instruments.
- Meet the debt covenants imposed by the Company's banking institution.

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12. Capital disclosure (continued):

The Company includes the following items in the management of capital: cash, cash equivalents, credit facility and shareholders' equity comprised of issued capital, contributed surplus and deficit. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions. The Company may adjust its capital structure in the future, by issuing shares and adjusting debt utilization. As at September 30, 2016 the Company's capital is as follows:

As at September 30	2016	2015
Cash and cash equivalents	\$ 31,138,643	\$ 25,000,615
Shareholders' equity	38,017,504	29,838,542
	<u>\$ 69,156,147</u>	<u>\$ 54,839,147</u>

The Company is subject to the following capital requirements relating to the covenants and conditions of its bank line of credit:

- The working capital ratio shall not be less than 1.1:1.
- The debt to tangible net worth ratio shall not at any time exceed 2.75:1.
- There will be no dividends, reduction in loans from shareholders, subsidiaries or related parties, or other withdrawals of similar nature without the prior consent of the bank.
- The bank reserves the right to require foreign receivables to be insured by the EDC with direction by the Company to pay all insurance proceeds to the bank.

The Company was in compliance with the above noted covenants as at September 30, 2016 and as at September 30, 2015.

13. Bank credit facility and restricted cash:

Since November 2007, the Company has had a bank operating line of credit with a major Canadian chartered bank. This credit facility was secured by a general security agreement based on trade accounts receivable and applicable inventory. In September 2012, this bank operating line of credit facility was further increased from \$500,000 up to maximum of \$1,000,000. This facility bears interest at the bank's prime plus 1.50% per annum. Formerly, this credit facility was additionally secured by a cash deposit of \$50,000 but this is no longer required and the deposit was returned plus interest earned thereon during Q2 2012. The line of credit was unused at September 30, 2016 and 2015.

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13. Bank credit facility and restricted cash (continued):

The Company also obtained a corporate credit card in September 2007. The credit card is secured by a \$53,743 cash deposit (includes interest of \$3,743). The deposit earns interest at prime minus 2.35%. The facility is subject to periodic review by the bank not less frequently than annually. All amounts outstanding under the credit facility are due on demand.

As at September 30	2016	2015
Credit card cash deposit	\$ 53,743	\$ 53,743
Balance as at September 30	\$ 53,743	\$ 53,743

14. Segmented information:

Photon Control designs, manufactures and distributes a wide range of optical sensors and instruments to measure temperature, pressure, position, and flow. These products are used by Original Equipment Manufacturers (OEM) as well as end-users in the Semiconductor, Oil and Gas, Power, Life Science, and Manufacturing industries. Photon Control's products have competitive advantages in both performance and cost. Photon Control's approach to creating shareholder value has been to pursue OEM sales whether directly or through a distributor and to investigate the market potential of products by working directly with customers in select industries to foresee their sectors' requirements. These collaborations often include commitments to conduct trials of the new products on industrial sites.

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14. Segmented information (continued):

(a) Geographic information:

Information regarding revenue earned from major customers by geographic segments, based on the location of the customer, is as follows:

	For the three months ended:		For the nine months ended:	
	Sep 30, 2016	Sep 30, 2015	Sep 30, 2016	Sep 30, 2015
Revenue				
Canada	\$ 414,664	\$ 219,311	\$ 814,030	\$ 327,400
United States	5,778,062	4,726,968	15,628,479	17,638,483
China	1,015,878	720,275	2,542,709	2,344,328
Europe	18,776	56,920	83,364	94,746
Other Asia	1,505,955	242,572	4,092,718	1,366,384
Total	\$ 8,733,335	\$ 5,966,046	\$ 23,161,300	\$ 21,771,341

(b) Assets and liabilities.

The Company has only one operation in Burnaby, British Columbia, Canada. All of the Company's assets (including cash, inventory, property plant and equipment, intangible assets) and liabilities are located in Canada.

(c) Major customers:

The following table identifies the percentage of revenue generated from individual customers comprising 5% or more of the Company's revenue:

As at September 30	2016	2015
Entity A	52%	47%
Entity B	11%	11%
Entity C	7%	21%
Entity D	6%	3%
Entity E	13%	4%
	89%	86%

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15. Trade payables and accrued liabilities

As at September 30	2016	2015
Trade payables	\$ 877,865	\$ 624,368
Accrued liabilities	597,933	1,085,518
Warranty provision	359,111	203,623
Balance as at September 30	\$ 1,834,009	\$ 1,913,509

The following is a reconciliation of the warranty provision during the nine months:

Reconciliation of warranty provision as at September 30	2016	2015
Balance, beginning of the year	\$ 259,292	\$ 217,880
Warranty costs incurred	(80,181)	(138,257)
Warranty provision - additions or changes	180,000	124,000
Balance as at September 30	\$ 359,111	\$ 203,623

Due to the uncertainty surrounding the timing of warranty returns, the entire provision has been classified as current.

16. Litigation

The following describes the outstanding agreements between the Company and Photon Control R&D Ltd. and summarizes the litigation between them.

R&D Agreement

In connection with a restructuring of the Company in 2008 to outsource its research and development division, the Company entered into an agreement dated as of October 1, 2008 (the "R&D Agreement") with Photon Control R&D Ltd. ("Photon R&D"). As Photon R&D had directors and shareholders in common with the Company, the R&D Agreement was considered a related party transaction under applicable securities regulation and stock exchange rules. Under the R&D Agreement, the Company transferred to Photon R&D certain of the Company's research and development division assets (the "Research Business Assets"), which consisted solely of the then research and development division employees of the Company (the "Research Employees") and specifically excluded the following items relating to the research and development business as then conducted by or on behalf of the Company (whether or not by the Research Employees) prior to October 1, 2008 (which items were to remain the property of the Company solely): trademarks or tradenames; intellectual property in any software and hardware developed; in-process research and development; products or patents under development; customer agreements; customer relationships; non-competition agreements; backlog of research and development contracts; licensing agreements; and leases.

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16. Litigation (continued):

The R&D Agreement also provided for the following:

- The entering into of an Inter-Company Agreement dated as of October 1, 2008 (the "Inter-Company Agreement") between the Company and Photon R&D to ensure ongoing research and development services and support for the Company's then present and future products and to govern the respective rights and obligations of the Company and Photon R&D in connection with research and development matters. The Company agreed to assign all research and development orders received by the Company to Photon R&D through issuance of service orders with specific details of and charges for services to be separately negotiated in good faith between the Company and Photon R&D and specified in service orders. In return, Photon R&D agreed to grant the Company preferred manufacturer status for products and manufacturing services required by Photon R&D. The Inter-Company Agreement provided that any intellectual property, including, without limitation, concepts, procedures, discoveries or know how ("Intellectual Property") developed by Photon R&D for the Company under or arising out of the service orders shall become and remain the property of the Company. The Company also agreed to sublease to Photon R&D a portion of the Company's premises for which Photon R&D was to pay the Company Photon R&D's proportionate share of monthly rent and utilities and premises-related items;
- The issuance by the Company of 600,000 Common Shares of the Company to Photon R&D. The Company acknowledged that it had saved potential severance payment obligations to the Research Employees with Photon R&D's acquisition of the Research Business Assets. Upon its receipt of these Common Shares, Photon R&D had agreed that it would allocate and transfer the Common Shares among and to the Research Employees in view of their agreeing to be transferred to Photon R&D for employment at reduced salaries compared to their salaries earned with the Company; and
- In consideration for the transfer of the Research Business Assets and the foregoing items, Photon R&D agreed to pay the Company the sum of \$315,000 (which was determined with reference to an independent valuation report on the restructuring that was obtained by the Company) to be satisfied by a promissory note from Photon R&D dated as of October 1, 2008 (the "Promissory Note") providing for the payment of the \$315,000 with interest at the rate of 3% per annum in equal monthly instalments of \$3,038.96 each, from and including the 1st day of April, 2010 to and including the 1st day of March, 2020.

Alterations and Addenda to the Inter-Company Agreement

In 2009, a royalty obligation was imposed on the Company in favour of R&D and the procedure outlined in the Inter-Company Agreement of using service orders to commission work by R&D for Photon's customers was no longer followed. At the time, neither Michael Weston ("Weston Sr."), President of the Company, nor his son Christopher Weston ("Weston Jr."), who succeeded him as President of the Company on October 6, 2009, disclosed to or sought approval from the Company's Board for either of these modifications to the relationship. In 2010, the Company and Photon R&D entered into an Addendum to the Inter-Company Agreement ("Addendum No. 1") to, among other things, formalize the payment of royalties by the Company to Photon R&D ranging from 10% to 25% based on sales generated by the Company (subject to items eligible for a royalty fee providing a gross margin of 50% as calculated by the Company each month), and to set out rates chargeable by Photon R&D for certain engineering services.

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16. Litigation (continued):

As of January 15, 2013, the Company and Photon R&D entered into another Addendum to the Inter-Company Agreement (“Addendum No. 2”), stated to be retroactively effective from January 1, 2012 for a ten-year term until December 31, 2022 with automatic renewal for one additional five-year term. Addendum No. 2 included the following:

- The addition of provisions stating that (i) Intellectual Property developed by Photon R&D for the Company under or arising out of service orders shall become and remain the property of Photon, (ii) Intellectual Property jointly developed by the Company and Photon R&D shall be and remain the property of both companies and (iii) Intellectual Property that is developed independently by Photon R&D shall be the property of Photon R&D;
- The introduction of a standby support fee of \$45,000 per month payable by the Company to Photon R&D for certain engineering services; and
- Confirmation and elaboration of the royalties payable by the Company to Photon R&D. Addendum No. 2 provided for the calculation of royalties based on the final selling price for part numbers shipped in a fiscal period by the Company multiplied by the applicable royalty percentage rate for that part number for that fiscal period. The royalty rates ranged from 10% to 25% depending on whether a part number incorporated all or substantially all new technology or was based on old technology and when the part number was released, and provided that no royalty was payable by the Company to Photon R&D for part numbers resulting in zero or negative gross margin when sold by the Company.

As of December 13, 2013, the Company and Photon R&D entered into another Addendum to the Inter-Company Agreement (“Addendum No. 3”) to provide for monthly interest at the bank prime lending rate plus 1% chargeable by the Company to Photon R&D for net receivables owing to the Company by Photon R&D (excluding the Promissory Note).

Addendum No. 1, Addendum No. 2 and Addendum No. 3 (collectively, the “Addenda”) were signed on behalf of the Company by Weston Jr., then President of the Company, without the knowledge or approval of the Board of Directors of the Company. The Addenda were signed on behalf of Photon R&D by Weston Sr., President of Photon R&D. Further to an unauthorized loan transaction that Weston Jr. caused the Company to enter into with Photon R&D, Weston Jr. was terminated as President and Chief Executive Officer of the Company on June 26, 2016. The details of the Addenda were brought to the attention of the independent members of the Board of Directors of the Company in the course of the investigation of unauthorized transactions with Photon R&D.

Legal Action

In August 2016, the Company commenced a lawsuit in the Supreme Court of British Columbia (the “Court”) against Photon R&D, Weston Sr., Weston Jr., David C. Dueck and Todd Wilke (the “Claim”). In the Claim, the Company alleges that the Addenda, which in effect purport to limit the Company’s rights and impose obligations on the Company and would constitute material changes to the Inter-Company Agreement (and the R&D Agreement), ought to be set aside as null and void. Among other things, the Company alleges that the Addenda were procured through undisclosed self-dealing, the undue influence of Weston Sr. and that the fiduciary and other duties owed to the Company by Weston Sr., Dueck and Weston Jr. were not fulfilled.

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16. Litigation (continued):

The Claim also alleges, among other things, that the defendants knowingly facilitated or participated in the breach of fiduciary duties owed to the Company. The Company also seeks preservation of its property by the appointment of a custodian over the intellectual property of the Company in the possession or control of Photon R&D and developed by Photon R&D for the Company's customers, an accounting of monies had and received by Photon R&D from the Company and a declaration of a constructive trust upon said monies, injunctions restraining Photon R&D from certain conduct, and damages for, among other things, breach of contract and breach of fiduciary duty. The defendants have filed a defence to the Company's claims and the Company's allegations have yet to be proven in court.

On September 1 and 2, 2016, the Company applied to the Court for interlocutory relief pending trial of the Claim given certain threats made in writing by Photon R&D in July 2016. In view of those threats and in order to protect the Company's legitimate business interests, the Court issued an judgment pending the conclusion of the litigation or other resolution of the Claim, directing among other things, the following:

- (a) That Photon R&D not dispose of or encumber any of the intellectual property which is contested between the Company and Photon R&D other than in the ordinary course of its business; and
- (b) That Photon R&D continue to allow the Company access to all intellectual property as previously done prior to Weston Jr.'s termination as an executive officer of the Company.

17. Subsequent Events:

Corporate Governance

During Q3 2016 Photon Control's Board has continued to implement measures to strengthen its management team, improve internal controls and ensure good corporate governance, including the appointment of Michael Goldstein as Chairman and Acting CEO, engaging forensic accounting and intellectual property auditors, and adding three new Directors - Ronan McGrath on July 21, 2016 and Michael Torok and Neil McDonnell on November 3, 2016.

Litigation

See Note 16 for a summary of litigation matters and any subsequent events.

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16. Subsequent Events (continued):

Outstanding Share Data

As at September 30, 2016, a total of 107,985,518 common shares were issued and outstanding following the exercise of 3,310,000 stock options in Q3. As at the date of this report, to date 109,185,518 common shares were issued and outstanding following the exercise of 1,200,000 stock options to date in Q4 2016. As at September 30, 2016 and as at the date of this report, 308,000 common shares were pending issuance in connection with the settlement of vested RSUs.

There were stock options to purchase 5,706,500 common shares of the Company outstanding as at September 30, 2016 and stock options to purchase 4,481,500 common shares of the Company outstanding as at the date of this report following the subsequent grant, exercise and cancellation of stock options in Q4 2016.

In Q2 2016, the Company granted to directors of the Company RSUs to be settled for an aggregate of 645,000 common shares of the Company upon vesting and settlement. Of these, 172,000 RSUs lapsed in Q3 2016. During Q3 2016, the Company granted RSUs for 129,000 common shares to a new director of the Company. As at September 30, 2016, the Company had RSUs outstanding for 702,000 common shares. Subsequently in Q4 2016, RSUs for an aggregate of 258,000 common shares were granted to two new directors of the Company. The Company currently has 960,000 RSUs outstanding.