



Consolidated Financial Statements of

PHOTON CONTROL INC.

For the years ended December 31, 2016 and 2015

Management's Responsibility

To the Shareholders of Photon Control Inc.:

Management is responsible for the preparation and presentation of the accompanying consolidated financial statements, including responsibility for significant accounting judgments and estimates in accordance with International Financial Reporting Standards. This responsibility includes selecting appropriate accounting principles and methods, and making decisions affecting the measurement of transactions in which objective judgment is required.

In discharging its responsibilities for the integrity and fairness of the consolidated financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of consolidated financial statements.

The Board of Directors and Audit Committee are composed primarily of Directors who are neither management nor employees of the Company. The Board is responsible for overseeing management in the performance of its financial reporting responsibilities, and for approving the financial information included in the annual report. The Board fulfils these responsibilities by reviewing the financial information prepared by management and discussing relevant matters with management and external auditors. The Audit Committee has the responsibility of meeting with management and external auditors to discuss the internal controls over the financial reporting process, auditing matters and financial reporting issues. The Board is also responsible for recommending the appointment of the Company's external auditors.

MNP LLP, an independent firm of Chartered Professional Accountants, is appointed by the shareholders to audit the consolidated financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically and separately with, the Board of Directors, Audit Committee and management to discuss their audit findings.

April 25, 2017

"Scott Edmonds"

Chief Executive Officer

"Gerald Adams"

Chief Financial Officer

Independent Auditors' Report

To the Shareholders of Photon Control Inc.:

We have audited the accompanying consolidated financial statements of Photon Control Inc., which comprise the consolidated statements of financial position as at December 31, 2016 and 2015, and the consolidated statements of comprehensive income, changes in equity and cash flows for the years then ended, and 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 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 the auditors' 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, the auditor considers 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 in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Photon Control Inc. as at December 31, 2016 and 2015 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.



Vancouver, BC
April 25, 2017

MNP LLP

Chartered Professional Accountants

PHOTON CONTROL INC.

Consolidated Statements of Financial Position

(Expressed in Canadian dollars)

As at December 31, 2016 and December 31, 2015

	December 31, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 32,507,966	\$ 26,227,017
Trade accounts receivable and other	5,172,655	3,566,245
Note receivable - related (note 8(a))	16,878	18,566
Due from related party (note 8(a))	189,080	178,336
Inventory (note 4)	3,246,935	2,634,010
Deposits	109,456	-
Prepaid expenses	120,526	36,832
Current assets	<u>41,363,496</u>	32,661,006
Property and equipment (note 5)	755,377	479,491
Intangible assets (note 6)	79,878	122,556
Long term rental deposits	24,920	34,695
Note receivable - related (note 8(a))	55,969	74,985
Restricted cash (note 13)	652,312	53,743
Deferred taxes (note 17)	258,828	318,350
Total Assets	\$ 43,190,780	\$ 33,744,826
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities (note 15)	2,035,007	1,244,123
Deferred revenue	\$ 50,256	\$ 68,325
Corporate tax payable (note 17)	419,554	610,462
Due to related party (note 8(a))	1,813,746	184,858
	<u>4,318,563</u>	2,107,768
Shareholders' equity (note 7):		
Share capital	29,137,457	28,217,623
Contributed surplus	3,493,678	3,694,121
Retained Earnings	6,241,082	(274,686)
	<u>38,872,217</u>	31,637,058
Litigation (note 16)		
Subsequent events (note 18)		
Total Liabilities and Shareholders' Equity	\$ 43,190,780	\$ 33,744,826

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board

"Scott Edmonds", Director

"Neil McDonnell", Director

PHOTON CONTROL INC.

Consolidated Statements of Comprehensive Income (Expressed in Canadian dollars)

For the years ended December 31, 2016 and 2015

	Year Ended December 31 2016	Year Ended December 31 2015
Revenue	\$ 32,171,996	\$ 27,574,653
Cost of sales	15,952,092	12,994,182
Gross Margin	16,219,904	14,580,471
Gross Margin Percentage	50.4%	52.9%
Operating expenses (notes 8 and 10):		
General and administrative	4,602,451	2,748,780
Engineering	1,244,979	835,485
Business development	939,148	564,373
Operating expenses	6,786,578	4,148,638
Net earnings before other earnings and tax	9,433,326	10,431,833
Other earnings (expenses):		
Interest and other earnings	141,041	90,426
Interest expense	(3,752)	(1,960)
Foreign exchange gain (loss)	(186,233)	1,694,804
	(48,944)	1,783,270
Net earnings before income tax	9,384,382	12,215,103
Income tax expense (note 17)	(2,809,092)	(1,190,823)
Deferred income tax expense (note 17)	(59,522)	(1,819,861)
Net earnings and total comprehensive income	\$ 6,515,768	9,204,419
Basic and diluted earnings (loss) per share		
Weighted average common shares used in computing	105,992,172	103,172,777
Diluted average common shares used in computing	113,619,998	112,342,419
Basic earnings per share	\$0.06	\$0.09
Diluted earnings per share	\$0.06	\$0.08

See accompanying notes to consolidated financial statements.

PHOTON CONTROL INC.
Consolidated Statements of Changes in Equity
(Expressed in Canadian dollars)
As at December 31, 2016 and 2015

For the year ending December 31, 2016

	Share Capital		Contributed Surplus and Deficit		
	Number of Shares	Amount	Contributed Surplus	Earnings	Total
Balance at December 31, 2015	103,971,518	\$ 28,217,623	\$ 3,694,121	\$ (274,686)	\$ 31,637,058
Stock based compensation	-	-	733,184	-	733,184
Share issues	5,851,500	1,315,239	-	-	1,315,239
NCIB share buy backs (Shares cancelled)	(319,500)	(85,229)	(202,302)	-	(287,531)
NCIB share buy backs (Shares in treasury)	(1,155,000)	(310,176)	(731,325)	-	(1,041,501)
Total comprehensive income	-	-	-	6,515,768	6,515,768
Balance at December 31, 2016	108,348,518	\$ 29,137,457	\$ 3,493,678	\$ 6,241,082	\$ 38,872,217

For the year ending December 31, 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	-	-	604,833	-	\$ 604,833
Share issues	1,786,000	306,074	(127,223)	-	\$ 178,851
Total comprehensive income	-	-	-	9,204,419	\$ 9,204,419
Balance at December 31, 2015	103,971,518	\$ 28,217,623	\$ 3,694,121	\$ (274,686)	\$ 31,637,058

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

PHOTON CONTROL INC.

Consolidated Statements of Cash Flows

(Expressed in Canadian dollars)

As at December 31, 2016 and 2015

As at December 31	2016	2015
Cash provided by (used in):		
Operations:		
Net earnings	\$ 6,515,768	\$ 9,204,419
Non-cash items:		
Depreciation of property and equipment	162,768	82,141
Amortization of intangible assets	55,409	47,451
Stock-based compensation	951,184	604,833
Accretion income	11,772	(10,755)
Amortization on gain on sale to R&D	(15,586)	20,422
Inventory reserve provision	129,000	99,000
Allowance for doubtful accounts	98,937	98,937
Deferred tax	59,522	1,819,861
Changes in non-cash operating working capital:		
Trade accounts receivable and other	(1,705,347)	345,893
Inventory	(741,925)	(941,676)
Deposits receivable- lease current	(109,456)	-
Deposits receivable- lease long term	9,775	-
Prepaid expenses	(83,694)	161,427
Accounts payable and accrued liabilities	818,921	(18,021)
Corporate tax payable	(190,908)	610,462
Due to/from related party	1,618,144	198,086
Contingent liabilities	(28,037)	-
Deferred revenue	(2,483)	(46,111)
	7,553,764	12,276,369
Financing:		
Shares buy-back (Normal Course Issuer Bid)	(1,329,032)	-
Shares issue proceeds (exercise of options)	1,097,239	178,851
Proceeds from note receivable	8,932	31,601
	(222,861)	210,452
Investments:		
Contingent liabilities - litigation	(598,569)	-
Purchase of equipment	(438,654)	(295,102)
Purchase of intangible assets	(12,731)	(26,083)
	(1,049,954)	(321,185)
Increase in cash and cash equivalents	6,280,949	12,165,636
Cash and cash equivalents, beginning of year	26,227,017	14,061,381
Cash and cash equivalents, end of year	32,507,966	26,227,017

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 years ended December 31, 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 financial statements of the Company for the year ended December 31, 2016 comprise the Company and its (inactive) subsidiaries. The financial statements were authorized for issue by the Board of Directors on April 25, 2017.

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 consolidated financial statements of the Company and its subsidiaries were prepared in compliance with the International Financial Reporting Standards (“IFRS”), as issued by the International Accounting Standards Board (“IASB”)

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 year ended December 31, 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 year ended December 31, 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 years ended December 31, 2016 and the year ended December 31, 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 year ended December 31, 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 year ended December 31, 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 year ended December 31, 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 year ended December 31, 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 undertaken. 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 year ended December 31, 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 year ended December 31, 2016 and 2015

3. Recently adopted and future accounting pronouncements:

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:

(a) In January 2016, the IASB issued IFRS 16 “Leases”, to set out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a lease contract. The standard supersedes IAS17, “Leases” and other related interpretations. The standard will be effective on October 1, 2019 for the Company with earlier adoption permitted only if IFRS 15 “Revenue from Contracts with Customers: is also applied. The Company is currently evaluating the impact of this standard on its consolidated financial statements.

(b) 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.

(c) 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.

PHOTON CONTROL INC.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars, unless specifically indicated otherwise)
For the year ended December 31, 2016 and 2015

4. Inventory:

As at December 31	2016	2015
Raw materials	\$ 1,538,051	\$ 1,282,005
Work in process	613,907	272,854
Finished goods	1,094,997	1,079,151
	<hr/>	
	\$ 3,246,935	\$ 2,634,010

For the year ended December 31, 2016, inventory recognized as an expense in cost of sales amounted to \$9,752,671 (December 31, 2015 - \$7,780,338). Included in the above amount for the year ending December 31, 2016 were inventory write downs of \$129,000 (year ending December 31, 2015 – \$99,000). There were no reversals of previously recorded inventory write downs for 2015 (December 31, 2015 - Nil).

As of December 31, 2016, the Company anticipates the net inventory will be realized within one year.

PHOTON CONTROL INC.

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5. Property and equipment:

	Laboratory equipment	Computers, office furniture and equipment	Production equipment	Construction in Progress	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	-	70,290	340,378	25,356	2,630	438,654
Disposals	-	-	-	-	-	-
Balance December 31, 2016	\$ 346,446	438,787	1,037,928	25,356	400,252	2,248,769
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	9,360	22,445	120,689		10,274	162,768
Disposals	-	-	-		-	-
Balance December 31, 2016	\$ 303,863	296,924	500,137	-	392,468	1,493,392
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 December 30, 2016	\$ 42,583	141,863	537,791	25,356	7,784	755,377

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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	-	-	12,731	-	12,731
Balance December 31, 2016	\$ 378,053	28,602	133,497	191,362	731,514

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	10,320	-	27,437	17,652	55,409
Balance December 31, 2016	\$ 347,080	28,602	125,770	150,184	651,636

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 December 30, 2016	\$ 30,973	-	7,727	41,178	79,878

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)	5,851,500	1,315,239
Share buy-back (Normal Course Issuer Bid)	(319,500)	(85,229)
Share buy-back (Shares still in treasury)	(1,155,000)	(310,176)
Issued and outstanding as at December 31, 2016	108,348,518	\$ 29,137,457

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 cancellation, up to 5,000,000 shares in its own stock. The NCIB period covers January 4, 2016 to January 3, 2017. Note: the 1,155,000 shares repurchased at a value of \$1,101,391 in December 2016 were still in treasury at December 31, 2016 and are thus included in shares issued and outstanding. These 1,155,000 were cancelled on January 4, 2017. All shares issues are due to exercise of share options or restricted share units.

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	733,184
NCIB share buy back 2016 (Shares cancelled)	(202,302)
NCIB share buy back 2016 (Shares in treasury)	(731,325)
Balance, December 31, 2016	\$ 3,493,678

PHOTON CONTROL INC.

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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	2,267,000	\$ 0.710
Granted	10,000	\$ 0.720
Granted	30,000	\$ 0.730
Granted	40,000	\$ 0.740
Granted	10,000	\$ 0.760
Granted	10,000	\$ 0.840
Forfeited	(5,000)	\$ 0.200
Forfeited	(690,000)	\$ 0.500
Forfeited	(10,000)	\$ 0.690
Forfeited	(590,000)	\$ 0.710
Expired	(10,000)	\$ 0.290
Expired	(10,000)	\$ 0.690
Exercised	(4,328,000)	\$ 0.100
Exercised	(10,000)	\$ 0.110
Exercised	(1,193,000)	\$ 0.150
Exercised	(5,000)	\$ 0.200
Exercised	(5,000)	\$ 0.300
Exercised	(2,500)	\$ 0.490
Outstanding, December 31, 2016	4,286,500	\$ 0.674

2,667,000 stock options were granted during the year ended December 31, 2016 (230,000 options granted for the year ended December 31, 2015).

PHOTON CONTROL INC.

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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 December 31, 2016, the Company has reserved 10,950,352 options (December 31, 2015 - 10,397,152 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 December 31, 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	160,000	0.72	\$ 0.100	160,000	\$ 0.100
\$0.150	457,000	1.75	\$ 0.150	457,000	\$ 0.150
\$0.165	10,000	1.76	\$ 0.165	7,500	\$ 0.165
\$0.295	10,000	2.01	\$ 0.295	5,000	\$ 0.295
\$0.300	15,000	2.13	\$ 0.300	7,500	\$ 0.300
\$0.310	10,000	2.07	\$ 0.310	5,000	\$ 0.310
\$0.320	10,000	2.24	\$ 0.320	5,000	\$ 0.320
\$0.425	20,000	2.68	\$ 0.425	10,000	\$ 0.425
\$0.490	17,500	3.11	\$ 0.490	4,375	\$ 0.490
\$0.500	1,330,000	3.13	\$ 0.500	1,330,000	\$ 0.500
\$0.620	10,000	3.38	\$ 0.620	2,500	\$ 0.620
\$0.650	10,000	4.03	\$ 0.650	-	\$ 0.650
\$0.660	10,000	3.89	\$ 0.660	2,500	\$ 0.660
\$0.670	270,000	4.55	\$ 0.670	-	\$ 0.670
\$0.690	130,000	3.73	\$ 0.690	67,500	\$ 0.690
\$0.700	40,000	4.11	\$ 0.700	30,000	\$ 0.700
\$0.710	1,677,000	4.55	\$ 0.710	7,500	\$ 0.710
\$0.720	10,000	4.20	\$ 0.720	-	\$ 0.720
\$0.730	30,000	4.45	\$ 0.730	-	\$ 0.730
\$0.740	40,000	4.54	\$ 0.740	-	\$ 0.740
\$0.760	10,000	4.62	\$ 0.760	-	\$ 0.760
\$0.840	10,000	4.45	\$ 0.840	-	\$ 0.840
	4,286,500	3.53	\$ 0.550	2,101,375	\$ 0.399

The options outstanding as at December 31, 2016 expire between September 18, 2017 and September 29, 2021.

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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	0.66% to 1.89%	.69% to 2.71%
Dividend yield	0%	0%
Volatility	95% to 208%	96% to 309%

During the year ended December 31, 2016, the Company recorded \$641,610 (2015 - \$604,833) of compensation expense representing the fair value of the options and shares vesting during the year 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 December 31, 2016:

Exercise price	RSUs outstanding			RSUs exercisable	
	Number of RSUs	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of RSUs exercisable	Weighted average exercise price
\$0.67	86,000	1.55	\$ 0.670	-	\$ 0.670
\$0.71	516,000	2.36	\$ 0.710	-	\$ 0.710
\$0.75	50,000	0.48	\$ 0.750	-	\$ 0.750
Total	652,000	2.24	\$ 0.710	-	\$ 0.710

PHOTON CONTROL INC.

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7. Share capital (continued):

(e) Net earnings (loss) per share:

The weighted average number of shares outstanding as at December 31, 2016 of 105,992,172 (December 31, 2015 – 103,172,777) were used in the calculation of basic earnings per share for the year ended December 31, 2016. 113,619,998 shares were used in the calculation of diluted earnings per share as at December 31, 2016 (December 31, 2015 - 112,342,419).

8. Related party balances and transactions:

(a) Related company balances and transactions:

During Q3 2016, the Company terminated all non-arm's length relationships with Photon Control R&D Ltd. and DCD Management Ltd. From the last quarter of 2016 financial statements, the related party transactions will be nil for both Photon Control R&D Ltd. and DCD Management Ltd.

All transactions with related parties had been translated in the normal course of operations and had been measured at the exchange amount, which was the amount of consideration established and agreed to by the related parties. Prior to the last quarter of 2016, related party transactions included 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 had reduced its internal research and development operations. DCD Management Ltd. provided financial, payroll and IT services. The Company had subleased space to Photon Control R&D Ltd. and DCD Management Ltd. at the same facility and charged both for premises and related expenses to recover the Company's costs. Amounts then outstanding with DCD Management Ltd. were non-interest bearing, unsecured and due on demand. Amounts then outstanding with Photon Control R&D Ltd. were unsecured and due on demand but, as of Q3 2014, outstanding balances were changed to interest bearing at prime plus 1%. These accounts are have been active and payments were received on a monthly basis, and the balance was 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 from the Company 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 therefore involved 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.

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8. Related party balances and transactions (continued):

The events following the above transaction as described in note 16 led to the termination of Photon Control R&D Ltd. and DCD Management Ltd. as related parties,

During 2009, the Company finalized and amended the terms of its agreement to transfer its research and development 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. As at December 31, 2016, the promissory note bore a coupon rate of 3% per annum, was repayable in equal monthly instalments of \$3,089 which began on April 1, 2010 and was to mature on March 1, 2020.

The following represents those applicable related party transactions to be recognized prior to the fourth quarter 2016.

As at	September 30, 2016 No longer related	Dec 31, 2015 Related
Statement of Financial Position		
Accounts receivable due from related party	\$ 105,610	\$ 178,336
Note receivable	78,023	93,551
Accounts payable and accrued liabilities	825,022	184,858
Statement of Comprehensive Income		
Charges to:		
Revenue from sales of products and services to Photon R&D	\$ 508,314	\$ 164,518
Payroll reimbursement re: Photon Control R&D Ltd.	905,998	1,424,389
Recovery of premises and other related expenses (Re: DCD Management Ltd. and Photon Control R&D Ltd.)	256,196	326,239
Intercompany interest	-	2,058
Charges from:		
Products & services charged by Photon Control R&D Ltd.	\$ 101,780	\$ 304,795
Engineering & R&D services charged by Photon Control R&D	748,496	751,646
Royalty expenses charged by Photon Control R&D Ltd.	1,645,852	1,779,059
Intercompany interest charged by Photon Control R&D Ltd.	1,585	1,078
Management services expenses charged by DCD Mgmt. Ltd.	\$ 53,039	\$ 225,993

While the litigation between the parties as described in note 16, was pending, the Company had stopped making certain payments related to the agreements with Photon Control R&D Ltd. The amounts that were potentially due under these agreements were being recorded as "Charges from" above in the Statement of Financial Position. The amounts that were paid or accrued in the last quarter in accounts payable were \$994,241.

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8. Related party balances and transactions (continued):

The promissory note receivable was being accreted up to its face value of \$315,000 by the effective interest method. As at December 31, 2016, \$53,963 (2015 - \$42,191) to date in accretion was recognized in interest income.

As at December 31	2016	2015
Promissory note receivable – face value	\$ 315,000	\$315,000
Less: discount	(97,513)	(97,513)
	217,487	217,487
Accretion	53,963	42,191
Principal repayment	(198,603)	(166,127)
Carrying amount	72,847	93,551
Current portion	(16,878)	(18,566)
Long-term portion	\$ 55,969	\$ 74,985

(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 officers.

Total compensation expense for key management personnel and the composition thereof, for the year ended December 31, 2016 is:

	2016	2015
Short term benefits including acting CEO consulting	\$ 553,500	\$ 684,472
Share-based compensation	577,942	224,576
Restricted Share Units	309,574	-
Carrying Amount	\$ 1,441,016	\$ 909,048

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 December 31, 2016, no bonus was 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 December 31, 2016, the Company has entered into premises leases requiring the following future minimum lease payments and related costs (applicable sales taxes extra) as follows:

2017	\$	561,619
2018		284,802
2019		284,802
2020		284,802
2021		284,802
2022		284,802
2023		284,802
2024		284,802
	\$	2,555,233

The Company has entered into a new lease with a term of January 1, 2017 to December 31, 2024 for a facility in Richmond, BC. Move date to this new facility will start April 17, 2017. 2017 lease expenses therefore will include rent and expenses for both the old Burnaby facility during the lease extension period from January 1 to April 30, 2017 as well as the new Richmond facility from January 1, 2017 onwards.

The above lease obligation for 2017 of \$561,219 includes amounts for the old Burnaby facility of \$276,817 and the new Richmond facility of \$284,802 with the four month overlap being due to construction of leasehold improvements.

For the year ended December 31, 2016, lease payments and related costs recognized as an expense amounted to \$825,928 (2015 - \$589,031).

The above amounts do not include any offset payments for subleases to two existing tenants which sublease portions of Photon Control Inc.'s existing facility. These tenants will not sublease any portion of the Company's new Richmond facility. Future minimum sublease payments expected to be received by Photon Control Inc. under non-cancellable subleases from January 1 to April 30, 2017 as follows:

2017	\$	80,196
	\$	80,196

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10. Supplementary information:

As at December 31	2016	2015
General and administrative:		
Salaries and consulting fees	\$ 1,379,611	\$ 1,197,491
Stock option compensation expense	886,553	585,382
Office premises expenses and rent	260,527	237,343
Travel	82,388	56,139
Professional and legal fees	1,617,771	369,884
Depreciation and amortization	77,808	46,530
Other expenses	297,793	256,011
	<u>\$ 4,602,451</u>	<u>\$ 2,748,780</u>
Engineering expenses:		
Engineering support and consulting fees	\$ 1,118,273	\$ 751,646
Depreciation and amortization	10,320	19,627
Other expenses	116,386	64,212
	<u>\$ 1,244,979</u>	<u>\$ 835,485</u>
Business development and marketing:		
Salaries and consulting fees	\$ 716,200	\$ 460,524
Depreciation and amortization	-	1,025
Other expenses	222,948	102,824
	<u>\$ 939,148</u>	<u>\$ 564,373</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 December 31, 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 December 31, 2016	At December 31, 2015
Cash and cash equivalents	Level 1	\$32,507,966	\$ 26,227,017
Total		\$32,507,966	\$ 26,227,017

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 statements of financial position. The Company had no other financial instruments recorded at fair value as at December 31, 2016, nor as at December 31, 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 years.

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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 December 31, 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. During the year ended December 31, 2016, the Board of Directors approved a new Investment Policy in order to strengthen 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 December 31, 2016 the maximum credit risk, which is the total of its uninsured trade receivables (primarily Canadian based customers and intercompany), was CAD \$278,800 or 6% (December 31, 2015 - \$331,190 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 December 31, 2016:

Current	31-60 days	61-90 days	91 days +
70%	24%	3%	3%

The following table provides information regarding the aged trade receivables as at December 31, 2015:

Current	31-60 days	61-90 days	91 days +
57%	37%	2%	4%

The Company holds its cash and cash equivalents at a major Canadian banking institution. As at December 31, 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 December 31	2016	2015
Balance, beginning of the year	\$ 155,000	\$ 51,774
(Write-offs) recovery of specific accounts	(138,163)	4,538
Change in provision	(8,042)	98,688
Balance as at December 31	\$ 8,795	\$ 155,000

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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:

December 31	2016	2015
Customer A	48%	40%
Customer B	15%	18%
Customer D	13%	8%
Customer C	4%	10%

(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 and 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. There are no forward exchange contracts in effect as at December 31, 2016 or 2015.

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 December 31, 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 December 31:

Amounts denominated in U.S. dollars as at December 31	2016	2015
Cash	\$10,278,778	\$ 2,425,187
Trade accounts receivable	3,480,840	3,473,617
Trade accounts payable	332,758	74,749

The estimated impact on net earnings at December 31, 2016 with a +/- 10% change in foreign exchange rates is **CAD \$1,802,825** (December 31, 2015 – CAD \$597,365).

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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 December 31, 2016, the Company's accounts trade payable and accrued liabilities were \$1,785,007 (December 31, 2015 - \$1,224,123) which fall due for payment within twelve months of the balance sheet date. As at December 31, 2016, the Company had access to a credit facility of \$1,000,000. This credit facility currently remains unutilized at December 31, 2016 (also unutilized as at December 31, 2015).

Significant cash commitments in years subsequent to December 31, 2016 are as follows:

	1 year	2 year	3 year	4 year	5 year	Total
Accounts trade payable and accrued liabilities	\$ 2,035,007	-	-	-	-	\$ 2,035,007
Corporate tax payable	419,554	-	-	-	-	419,554
Photon Control R&D Ltd ("R&D") payable	1,813,746	-	-	-	-	1,813,746
Closing costs to resolve litigation with "R&D"	1,501,919	-	-	-	-	1,501,919
Lease obligation	561,619	284,802	284,802	284,802	284,802	1,700,827

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 \$2,181,214 for the year ended December 31, 2016 (December 31, 2015 - \$1,779,059). These royalties are to be reduced from 10% for the year ending December 31, 2016 to 4.25% for the next year ending December 31, 2017. (See Note 16: Litigation).

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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.

The Company includes the following items in the management of capital: cash and 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 December 31, 2016 the Company's capital is as follows:

As at December 31	2016	2015
Cash and cash equivalents	\$ 32,507,966	\$ 26,227,017
Shareholders' equity	38,872,217	31,637,058
	<u>\$ 71,380,183</u>	<u>\$ 57,864,075</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 December 31, 2016 and as at December 31, 2015.

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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 December 31, 2016 and 2015.

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.

In October 2016, Photon Control R&D Ltd win connection with litigation, proceedings (See Note16: Litigation), obtained a court order to garnish \$598,569 regarding disputed accounts payables from the Company. These funds were deposited with the Court pending completion of judgment by the court, the Company's application to the Court to release these funds or an out of court agreement between the two parties. The payable related to these garnished amounts has been accrued as noted.

As at December 31	2016	2015
Garnished funds (held in trust by the Court)	\$ 598,569	\$ -
Credit card cash deposit	53,743	53,743
Balance as at December 31	\$ 652,312	\$ 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 years ended	
	Dec 31, 2016	Dec 31, 2015
Revenue		
Canada	\$ 816,245	\$ 429,864
United States	24,636,959	21,454,126
China	2,542,709	3,464,372
Europe	81,806	116,513
Other Asia	4,094,277	2,109,778
Total	\$ 32,171,996	\$ 27,574,653

(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 with the exception a portion of inventory at a third party warehouse in California (with a value of \$296,718 as at December 31, 2016)

(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 December 31	2016	2015
Entity A	50%	47%
Entity E	13%	4%
Entity B	12%	19%
Entity C	8%	13%
Entity D	5%	3%
	88%	86%

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15. Trade payables and accrued liabilities

As at December 31	2016	2015
Trade payables	\$ 1,019,080	\$ 352,067
Accrued liabilities	443,672	549,915
Warranty provision	572,255	259,292
Balance as at December 31	\$ 2,035,007	\$ 1,161,274

The following is a reconciliation of the warranty provision during the year:

Reconciliation of warranty provision as at December 31	2016	2015
Balance, beginning of the year	\$ 259,292	\$ 217,880
Warranty costs incurred	(112,037)	(192,616)
Warranty provision - additions or changes	425,000	234,028
Balance as at December 31	\$ 572,255	\$ 259,292

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

16. Litigation

The following describes, as at December 31, 2016, the litigation proceedings between the Company and Photon R&D, all of which have been resolved as of the date of these financial statements.

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 R&D. As Photon R&D had directors and shareholders in common with the Company, consisting of the Company's Chairman and largest shareholder, as well as the Company's President and CEO, the R&D Agreement was considered a related party transaction under applicable securities regulation and stock exchange rules ("R&D Transaction"). See Note 8 "Related Party Transactions and Balances" for a description of the R&D Transaction.

Between 2009 and 2013, pursuant to various addenda ("Addenda") entered into between the Company and Photon R&D, the R&D Agreement came to include not just payments for services but also standby payments for engineering services, royalty payments ranging from 10% to 25% of product sales, as well as including certain rights for R&D to own and control or share control over certain of the products and intellectual property produced under the R&D Agreement. Administrative tasks and management were added to the relationship.

In August 2016, the Company commenced a lawsuit in the Supreme Court of British Columbia (the "Court") against Photon R&D and others (the "Claim"). In the Claim, the Company claimed

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16. Litigation (continued):

that the Addenda, which in effect purported to limit the Company's rights and impose obligations on the Company and constituted material changes to the R&D Agreement, should be set aside as null and void.

In September 2016 and in December, 2016, the Company applied to the Court for interlocutory relief pending trial of the Claim. The Court granted the Company, among other things, a right of access to all IP developed by Photon R&D for the Company, prohibited Photon R&D from initiating contact with the Company's customers and prohibited Photon R&D from manufacturing products for the Company's customers, with minor exceptions.

At December 31, 2016, the outcome of this lawsuit was indeterminable and nothing has been recorded in the financial statements other than the accruals to Photon R&D based on the terms of the then existing R&D Agreement. As per Note 8, these amounts were no longer being paid to Photon R&D after Q3, but, as at December 31, 2016, the Company had continued to accrue them until the disposition of the lawsuit.

The Claim was resolved in April, 2017. See Note 18 "Subsequent Events" for details.

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17. Income Tax

The following table reconciles the expected income tax expense (recovery) at the Canadian statutory income tax rates to the amounts recognized in the consolidated statements of operations for the years ended December 31, 2016 and 2015:

	2016	2015
Loss before income taxes	\$ 9,384,382	\$ 12,215,103
Statutory tax rate	26.00%	26.00%
Expected income tax (recovery)	2,439,939	3,175,927
Non-deductible expense	254,381	158,521
Change in estimates	174,294	-
Total income tax expense (recovery)	\$ 2,868,614	\$ 3,010,684
Current tax expense (recovery)	2,809,092	1,190,823
Deferred tax expense (recovery)	59,522	1,819,861
Total income tax expense (recovery)	\$ 2,868,614	\$ 3,010,684

Deferred taxes reflect the tax effects of temporary differences between the carrying amounts of assets and liabilities for the financial reporting purposes and their tax values. Deferred tax assets (liabilities) at December 31, 2016 and 2015 are comprised of the following:

	2016	2015
Property and equipment	\$ 80,896	\$ 173,937
Intangible assets	3,422	3,679
Reserves	163,956	127,119
Notes receivable	10,554	13,615
	\$ 258,828	\$ 318,350

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18. Subsequent Events

Litigation

On April 9, 2017, the Company signed a binding agreement with Photon R&D which sets out the terms of a settlement to resolve all legal actions commenced by the Company against Photon R&D and certain others, as well as the counter-claims filed by R&D against the Company. This agreement closed April 14, 2017. Pursuant to the settlement, the Company will acquire full ownership of all intellectual property, products, trademarks and other assets previously under dispute, and Photon R&D employees will be transferred to the Company.

In consideration, the Company will pay a percentage of sales revenue to R&D commencing January 1, 2017 for a period of 5 years, equal to 4.25% of revenues from sales of products currently under license from or incorporating intellectual property developed by R&D. Also the Company is committed to paying the former CEO, who resigned on June 26, 2016, the sum of \$400,000 and purchase the inventory and equipment of R&D for \$130,000 and \$640,000 respectively. The Company will also pay R&D for past due royalty amounts to December 31, 2016.

Outstanding Share Data

As at December 31, 2016, a total of 108,348,518 common shares were issued and outstanding. As at the day of this report, the Company still had 108,348,518 common shares issued and outstanding.

As at December 31, 2016, there stock options to purchase 4,286,500 common shares of the Company outstanding. Subsequently, as at the date of this report, the Company had 3,857,000 share options outstanding.

As at December 31, 2016, the Company had RSUs outstanding for 652,000 common shares. As if the day of this report the Company still had RSUs outstanding for 652,000 common shares