PHOTON CONTROL INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS

For the second quarter ended June 30, 2012
(Unaudited)

This Management's Discussion and Analysis ("MD&A") of Photon Control Inc. ("Photon Control" and the "Company") is dated August 29, 2012. This MD&A should be read in conjunction with the unaudited interim consolidated financial statements and accompanying notes for the period ended June 30, 2012, and the Audited Consolidated Financial Statements and accompanying notes as at and for the years ended December 31, 2011 and 2010.

Forward-Looking Statements

This MD&A contains forward looking statements, including statements regarding the business and anticipated financial performance of the Company, which involve risks and uncertainties. These risks and uncertainties may cause the Company's actual results to differ materially from those contemplated by the forward-looking statements. Factors that might cause or contribute to such differences include, among others, uncertainty as to the Company's ability to successfully complete new purchase orders along the timelines expected; the Company's need for funds to achieve its goals and uncertainties as to the availability and cost of financing the Company; uncertainty as to the continued and future demand for the Company's products; the Company's present reliance on four major customers for the majority of its sales; the Company's reliance on the financial health of the semiconductor industry, a vital part of its sales; the Company's ability to continue and further enhance revenue diversification and open new market opportunities; the development of competing technologies and the possibility of increased competition; the effect of slow growth in the United States, its principal market, as well as in Canada and other economies generally and other economic trends and conditions in the markets that the Company and its customers serve; risks associated with technical difficulties or delays in product introductions, improvements, implementation, product pricing or other initiatives of the Company and its competitors; factors that may result in a reduction in capital expenditures and/or delayed buying decisions affecting demand for the Company's products; currency fluctuations particularly between the Canadian and United States dollars; and risks in pursuing additional development projects in order to support existing customers or pursue other business opportunities.

Forward-looking statements are based on the beliefs, opinions and expectations of the Company's management at the time they are made, and the Company may, but does not assume any obligation to, update its forward-looking statements if those beliefs, opinions or expectations, or other circumstances, should change except as may be required by applicable securities laws. Readers should not place undue reliance on forward-looking statements.

BUSINESS OVERVIEW

Photon Control Inc. designs and manufactures 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 provide high accuracy and reliability in extreme conditions and are supported by a team of experts that offer onsite installation, training, and support. Photon Control Inc. also provides engineering services for customized optical measurement systems. Headquartered in an ISO 9001:2008 manufacturing facility in Burnaby, BC, Photon Control Inc. is listed on the TSX Venture Exchange, trading under the symbol ''PHO".

Photon Control's approach to creating shareholder value has been to pursue OEM sales whether directly or through distributors 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.

Photon Control's measurement and control instruments are intended for applications with high demands for precision, repeatable performance and reliability. The semiconductor manufacturers that are Photon Control customers set very high standards of supply chain management and Photon Control has satisfied these requirements.

Photon Control supplies products to its 'Fortune 500' customer base through integrator contractors located in the USA, Europe, and Asia, and directly supplies products to a second major capital equipment manufacturer located in Silicon Valley.

While focusing on manufacturing and distribution of high-quality products, Photon Control has a strong business relationship with Photon Control R&D Ltd., an engineering and research and development company, in order to enhance the effectiveness of its technical and customer support team and convert the Company's intellectual property (consisting of 19 issued and 6 pending patents) into commercial products.

Photon Control has a strong and highly skilled employee base and has successfully managed to recruit and retain qualified personnel through competitive employment terms relative to the local labour market.
As at June 30, 2012 Photon Control staff included 30 full-time personnel representing a modest decrease of 6%, compared to 32 full-time personnel at the end of Q2 2011, due to departments' restructuring.

COMMERCIALIZED PRODUCTS AND BUSINESS TRENDS

The Company is supplying or starting to provide commercial products to the following market verticals through direct sales and in some cases through distributors for particular territories.

Manufacturing - Semiconductor Capital Equipment:	• OEM optical sensing solutions (optical sensors for positioning, spacing, detection, and related controls, robot alignment and positioning jigs, analytical tools for inspection of silicon wafers) or Silicon Wafer Sensing • Optical sensors (Immersion and Contact temperature measurement systems) • UV / VIS / NIR Spectrometers, Light Sources and Accessories
Oil, Gas & Petrochemical:	• Focus® Optical Flow Meters for measurement of stack emissions (greenhouse gases, flares), fuel gas, associated gas, coal bed methane, biogas • Total Sulphur Analyzer for measurement of total sulphur content in diesel, gasoline, kerosene, jet fuel, and other processed hydrocarbons • Downhole Pressure & Temperature Sensor system for SAGD extraction processes in Oil Sands applications
Power & Energy:	• PowerTemp Series single-channel and multi-channel temperature measurement systems for monitoring of transformers, switchgear and power generators
Life Sciences:	• UV / VIS / NIR Spectrometers, Light Sources and Accessories • Optical sensors (Life Science temperature measurement systems)
Institutional:	• UV / VIS / NIR Spectrometers, Light Sources and Accessories • Optical sensors (Immersion and Contact temperature measurement systems)
Food and Drug:	• UV / VIS / NIR Spectrometers, Light Sources and Accessories • Optical sensors (Immersion and Contact temperature measurement systems)

CORPORATE VISION AND STRATEGY

Although economic and market uncertainties, including a number of challenges such as ongoing market and supply chain volatility, price sensitivity and exchange rate fluctuation, required Photon Control and its customers to reposition its business plans over the past few years, Photon Control remains focused and fully committed to its core values and long-term growth strategy.

Some of Photon Control's key operational objectives are to:

- Enhance its sales opportunities on a global scale;
- Steadily expand manufacturing efficiency, capacity and recruitment in order to meet customer demands;
- Implement operating cost structures that align with overall revenue;
- Create efficient financial planning and maintain strong budget controls in order to quickly adapt to new and changing market conditions;
- Renegotiate contracts with vendors and suppliers to obtain more favourable terms; and
- Adhere to strict inventory control procedures.

These activities are important development areas in continuing liquidity management and organizational efficiency in 2012.

SELECTED ANNUAL INFORMATION

Certain of the comparative figures in the following table (specifically 2010) have been reclassified to conform with the IFRS presentation adopted for 2011.

Canadian Dollars	**Six Months Ended June 30**		
	2012	**2011**	**2010**
Total revenues	$ 5,887,249	$ 6,764,085	$ 7,451,432
Income before discontinued operations and extraordinary items	$ 1,214,280	$ 832,855	$ 1,903,809
Income per share before discontinued operations and extraordinary items, basic and diluted	0.01	0.01	0.02
Net income before taxes	$ 1,214,280	$ 832,855	$ 1,903,809
Net income per share, basic and diluted	0.01	0.01	0.02
Total assets	$ 12,360,363	$ 7,471,645	$ 5,754,659
Total long-term financial liabilities	—	$ 353,542	$ 414,450
Cash dividends declared per common share	—	—	—

SECOND QUARTER 2012

Highlights of Q2 2012

- Sales of $2.8 million (Q2 2011: $3.5 million)
- Operating Expenses of $0.5 million (Q2 2011: $1.0 million)
- Profit before taxes of $622,853 (Q2 2011: $377,189)
- Gross Margin of 37% (Q2 2011: 40%)
- Sales Order Backlog of $1.5 million (Q2 2011: $2.0 million)

Sales

Photon Control's sales revenue for the three months ended June 30, 2012 were $2.8 million, representing a decrease of $0.7 million or approximately 20% compared with $3.5 million during the same period last year.

Expenses

General and administrative expenses totalled $349,112 in Q2 2012 compared to $699,522 in Q2 2011. This decrease primarily reflects a reduction in legal costs of approximately $320,000 (see section "Litigation").

Research and development expenses totalled $80,515 in Q2 2012 compared to $207,566 in Q2 2011. This decrease is primarily caused by a reduction of staff and consulting fees.

Business development and marketing expenses totalled $41,767 for Q2 2012. This decrease, when compared to $58,161 in Q2 2011, reflects an addition of inside sales staff, to take advantage of increased market opportunities, but offset by a reduction in trade shows expenses due to later scheduling.

The net profit for Q2 2012 was $622,853 compared with a net profit of $377,189 in the corresponding period of 2011, representing an increase of $245,664 or approximately 65%. These results were in line with the Company's solid sales volumes, and lower operating expenses and legal fees.

RESULTS OF OPERATIONS AND Q2 2012 OVERVIEW

In 2010, Photon Control achieved many crucial milestones in both business and customer segments, resulting in the record annual sales and profit figures of $13.3 million and $2.7 million respectively. These results were mainly attributed to an improved economic environment including the rebound in the semiconductor sector, supported by non-semiconductor order activity, and in combination with Photon Control's established operational efficiency programs. In 2011, Photon Control achieved its second highest annual sales level of $11.5 million.

During the first six months of 2012, Photon Control continued to identify and evaluate opportunities to enhance its operational results and to diversify its product range, and has sought to open new market opportunities and revenue streams. Also, Photon Control saw improvement in sales volumes and profit results when compared to the second half of fiscal 2011.

Although the revenues from the semiconductor industry have historically fluctuated from quarter to quarter, during the second quarter of 2012 Photon Control recorded solid sales to this sector, supported by a steady flow of non-semiconductor product sales.

As previously announced in Q2 2012, Photon Control released the new FluoTemp GT-HT Temperature Converter to Photon Control's Optical Sensor product line. The new FluoTemp GT-HT temperature converter combines high accuracy, reliability and enhanced diagnostics even when exposed to high temperature and electro-magnetic interference (EMI) environments. The FluoTemp GT-HT features a robust aluminum enclosure that is designed specifically for high EMI applications in a wide range of industries such as Semiconductor, Power and Life Sciences where precision and accuracy are critical.

The Company continues to analyze and monitor industry trends and customer needs in order to ensure proper budgeting and operational efficiency programs, and remains encouraged by a solid sales order backlog of $1.3 million as of the day of this report.

As at June 30, 2012 the Company's $500,000 bank line of credit was not utilized due to the increase in cash flow from operations. However, the line of credit was and is available for use if needed. Although there can be no assurances, Photon Control believes that cash generated from operations, committed purchase orders, and the availability of the Company's line of credit will give Photon Control financial resources necessary to operate in the current year and the foreseeable future.

MARKETING AND RECENT DEVELOPMENTS

Photon Control has broad geographic representation with dedicated distributors in North America, Europe, Asia, and Australia. The Company's expanded sales and marketing efforts are resulting in the success of securing orders from new customers as well as follow-on orders from existing customers.

In Q2 2012, Photon Control continued to evaluate new opportunities by focusing on marketing and business development and addressing both the current and future demands of its market. Also, the Company has expanded the sales and marketing department by bringing on a Technical Sales Representative to focus on Spectroscopy product sales to universities, labs and research facilities in Canada and the United States. In addition, Photon Control has signed on two new Distributors in the Asia Market for Optical Flow Meters in Malaysia, and for Optical Sensors and Spectroscopy for the Semiconductor industry in Korea.

Product Sales and Operational Update

The Company's product sales for the second quarter of 2012 were $2.8 million, representing a decrease of approximately 20% compared to $3.5 million during the same period last year, primarily due to a slowdown in the semiconductor sector. For the six months ended June 30, 2012 product sales were $5.9 million compared to $6.8 million for the same period in 2011.

However, the Company's net profit for both the three and six months ended June 30, 2012 reported an increase when compared to the same periods in 2011. The net profit for Q2 2012 and for the six months ended June 30, 2012 was $622,853 and $1,214,280 respectively, compared to the net profit of $455,664 and $832,855 for the same periods in 2011. The net profit before taxes ended June 30, 2012 has already surpassed the net profit before taxes of $720,733 for the entire year ended December 31, 2011.

The Company continued to experience a solid volume of orders from the semiconductor sector. In addition, the continued inflow of orders from the non-semiconductor sector contributed approximately 12% of the second quarter 2012 total sales and this revenue included the sales of analytical products, flare gas meters, fibre optic temperature sensors and spectrometers.

Gross Margin Percentage

The gross margin percentage for Q2 2012 was 37% representing a decrease when compared to the Q2 2011 gross margin percentage of 40%. The reduction of gross margin percentage during 2011 and 2012 was primarily due to a decrease in overall revenue, plus sales of less favourable margin products and additional provisions for obsolete inventory.

Operating Expenses

General and administrative expenses totalled $349,112 in Q2 2012 compared to $699,522 in Q2 2011 due to increase in:

- salaries of $15,934
- bad debt expense of $10,000

but offset by a decrease in:

- legal expenses of $320,718
- other expenses of $55,625

Research and development expenses totalled $80,515 in Q2 2012 compared to $207,566 in Q2 2011 primarily due to a decrease in:

- salary expense of $50,464 due to a staff reduction
- consulting fees of $66,750
- other expenses of $9,837

Business development and marketing expenses totalled $41,767 for Q2 2012 compared to $58,161 in Q2 2011 primarily due to increase in:

- salaries of $12,403

but offset by a decrease in:

- promotion/trade shows of $24,955 (mainly due to the trade show scheduling)
- travel expenses of $2,123
- other expenses of $1,719

Other Expenses

Photon Control's products are priced in U.S. dollars. A fluctuating U.S. dollar resulted in a foreign exchange gain of $44,725 in Q2 2012 (which largely offset an exchange loss of $44,020 in Q1 2012) compared to a foreign exchange loss of $53,730 in Q2 2011.

Net Earnings

The net earnings before taxes for Q2 2012 were $622,853 compared to net earnings of $377,189 in Q2 2011. This was primarily attributed to a decrease in legal fees of $320,718, a decrease in engineering department expenses (due to restructuring) of $127,051, a decrease in foreign exchange losses of $98,455, but offset by a drop in gross margin of $351,637 compared to Q2 2011.

ORDER BACKLOG

The second quarter of 2012 continued to report a strong sales order backlog. At June 30, 2012 Photon Control's sales order backlog stood at $1.5 million. This represents the value of sales orders already fulfilled in Q3 2012 and/or waiting to be fulfilled in 2012. As at the date of this report, Photon Control's sales order backlog stood at $1.3 million.

SUMMARY OF QUARTERLY RESULTS

The following table is a summary of Photon Control's financial results for the past eight quarters. Certain of the comparative figures in the following table have been reclassified to conform with the presentation adopted for 2010.

	June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011	December 31, 2010	September 30, 2010
Revenue	$ 2,815,522	$ 3,071,727	$ 1,981,770	$ 2,740,028	$ 3,513,782	$ 3,250,303	$ 2,861,217	$ 2,960,614
Net income / loss before taxes	$ 622,853	$ 591,427	$ (516,957)	$ 404,836	$ 377,189	$ 455,664	$ 172,947	$ 639,182
Net income / loss per share Basic & Diluted	$ 0.01	$ 0.01	$ (0.01)	$ 0.01	$ 0.00	$ 0.01	$ 0.01	$ 0.01

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents at June 30, 2012 had a balance of $1,666,553 compared to $975,108 as at June 30, 2011. The Company had working capital of $4,762,787 as at June 30, 2012 compared to working capital of $4,624,144 as at June 30, 2011. The increase in working capital in 2012 was primarily due to an increase in cash.

Cash provided by operations totalled $657,130 for the six months ended June 30, 2012 compared to ($420,203) for the six months ended June 30, 2011. Investing activities used cash of $15,685 for the six months ended June 30, 2012 compared to $87,675 for the six months ended June 30, 2011. Cash used in financing activities were $nil in Q2 2012 compared to $nil in Q2 2011 relating to the Company's credit facility.

As at June 30, 2012, the Company's accounts payable and accrued liabilities were $809,178 which fall due for payment within twelve months of the balance sheet date compared to $1,412,342 as at June 30, 2011.

Nature of Business and Continuing Operations

The Company has made efforts to diversify the industries that it serves in an attempt to reduce the impact of a downturn on any one segment. The continued manufacturing and distribution of existing products and the commercialization of new products in 2011 and 2012 form the basis of management's opinion that the Company will meet its liabilities and commitments as they become due. The Company is constantly monitoring all expenditures and implementing cash management strategies to ensure that it has adequate cash reserves to fund identified expenditure requirements.

The Company is working with its bank to secure financing over and above the $500,000 line of credit it currently has (based on adding non-proprietary raw materials to bank covenants). In addition, the Company has insured its receivables in order to receive additional asset-based financing.

Contractual Obligations

Leases:

The Company has entered into premises leases requiring the following minimum lease payments as follows:

2012 (As of June 30)	314,840
2013	674,852
2014	720,572
2015	766,245
2016	812,047
	$ 3,288,556

In November 2011, the Company renewed its premises lease covering the period of January 2012 to December 2016. No deferred rent is applicable with this new lease.

Litigation:

In October 2001, a former member of management and President of the Company (the "Claimant") initiated an arbitration proceeding asserting that certain amounts were owing to him by the Company. The Company had commenced an action against the Claimant for a declaration that it had properly rescinded a loan agreement between the Company and the Claimant dated March 5, 2001 (the "Loan Agreement") and that the debt owed to the Claimant (the "Claimant Debt"), being $340,887 as at the date of the Loan Agreement, was repayable in shares of the Company at a rate of one share per dollar of debt. In addition, the Claimant has filed a claim against the Company seeking unspecified damages for wrongful dismissal. The Company considered the allegations in the lawsuit to be without merit and subsequently proceeded to defend the action.

The Company's application to dismiss the claim was denied in September 2009. The trial commenced on May 9, 2011 but did not complete on May 20, 2011 as scheduled. The trial resumed on June 13 and was completed on June 17, 2011.

As announced in the News Release dated August 2, 2011, the Supreme Court of British Columbia has released a decision that the Company did not have the right to rescind the Loan Agreement and that this debt is repayable in accordance with the Loan Agreement. The amount of the Claimant Debt payable is $374,562 including interest as at September 30, 2010 plus interest thereafter. The Court also ruled that the Claimant was dismissed without cause in 2001 and awarded 18 months notice at $130,000 per year in salary plus the value of the benefits payable to him.

As announced in the News Release dated September 12, 2011, Photon Control has filed a Notice of Appeal from the decision of the Supreme Court of British Columbia, and the appeal is from the Court's decision on both rescission of the loan agreement and the dismissal of the Claimant from the Company. Subsequently, the Company's appeal of both the loan agreement decision and the wrongful dismissal decision was heard by the British Columbia Court of Appeal on March 15 and 16, 2012.

As announced in the News Release dated August 16, 2012, the Court of Appeal dismissed the Company's appeal and upheld the trial decision that the Company did not have the right to rescind a loan agreement with Mr. Kidder and that Mr. Kidder had been dismissed without cause. The Company is considering its options of further appeal regarding the decision.

A charge for the Claimant Debt in the amount of $310,499 was previously taken by the Company as a long term liability and was reported on the Company's previous financial statements. Subsequently, the Company recorded an additional $539,501 in Q4 2011 to reflect the decision of the Court and the current estimate of this claim. Both of these amounts, totalling $850,000, were classified in Q4 2011 as a contingent liability (dependent upon the results of the appeal in the current fiscal 2012) per IAS 37. Related to this issue, the Company has provided a $850,000 standby irrevocable letter of credit as a guarantee against this lawsuit (included in restricted cash). Appropriate adjustments to the charge will be made in the Company's future 2012 financial statements to reflect the decision of the Court.

RELATED PARTY TRANSACTIONS

All transactions with related parties have been recorded 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. 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.

The Company subleases space to Photon Control R&D Ltd. at the same facility. The Company charges Photon Control R&D Ltd. premises and related expenses to recover the Company's costs. Amounts outstanding with Photon Control R&D Ltd. are non-interest bearing, unsecured and due on demand. This account is active and payments are received on a monthly basis, and the balances paid out at least twice during the year.

Six Months ended June 30	2012	2011
Balance Sheet:		
Accounts receivable	$ 798,938	$ 920,620
Note receivable	178,224	184,552
Accounts payable	97,056	117,460
Statement of Operations:		
Recovery of premises and related expenses	$ 107,907	$ 87,183
Payroll reimbursement	665,229	487,831
Engineering, research and development services	163,484	260,254
Royalties	201,569	85,124
Revenue from sales of products and services	61,792	117,227

The Company indemnifies its directors and officers against any and all claims or losses reasonably incurred in the performance of their service to the Company to the extent permitted by law. The Company has acquired and maintains liability insurance for directors and officers of the Company.

SUBSEQUENT EVENTS

In Q3 2012, Photon Control participated in the Semicon West trade exhibition in San Francisco, California. The Company presented its Spectrometer and Optical Sensor product lines, unveiled the new FluoTemp GT-HT temperature converter, as well as promoted its OEM manufacturing capabilities.

In addition, Photon Control met with distributors and customers at the trade exhibition to identify and discuss new market opportunities and expansion strategies. Also, during the third quarter of 2012, the Company has signed a new distributorship agreement in the Asian market for Spectrometers and Optical Sensors.

In September 2012, Photon Control will be participating in the World Heavy Oil Congress in Aberdeen, Scotland and will be presenting the Focus® Optical Flow Meter and Downhole Pressure and Temperature Sensor.

See "Litigation" for subsequent events with respect to litigation issues.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. A summary of the significant accounting policies used in the preparation of our financial statements is included in Note 2 of the consolidated financial statements for the six months ended June 30, 2012. The measurement of certain assets and liabilities is dependent upon future events, the outcome of which will not be fully known until future reporting periods. Therefore, the preparation of the consolidated financial statements requires management to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results will vary from those estimated. Certain accounting policies are critical to understanding our reported financial results. These critical policies, which affect the reported amounts of revenue and the more significant areas involving management estimates, are described here.

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 an actual FIFO cost basis and includes the cost of direct material, direct labour and other overhead costs. Labour costs are allocated to items based on actual labour hours input. Fixed and variable overhead are allocated to production activities in converting materials to finished goods.

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 the fee is fixed and determinable. Cash collected prior to revenue recognition criteria being met is recorded as deferred revenue on the consolidated balance sheet.

Research and Development Costs

Research costs are expensed as incurred. Development costs are expensed as incurred unless they meet the required criteria for deferral and amortization. There were no additional costs which were deferred in 2011 relating to development of a portable sulphur analyzer product. The Company amortizes previously deferred development costs, commencing with commercial production, over the expected future benefit period based upon quantities delivered compared to expected levels contracted to be delivered. In 2010, commercial production commenced but was postponed in 2011 so the amount amortized for the six months ended June 30, 2012 was $nil (June 30, 2011 - $nil). The Company has a balance of $150,616, (2011 - $152,724) of deferred development expenses as at June 30, 2012. As at December 31, 2011 and June 30, 2012, these deferred development expenses were not deemed to be impaired.

Stock-based Compensation Plans

The Company accounts for employee stock options using the fair value based method. Under the fair value based method, 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 based method.

30,000 stock options were granted during the three months ended June 30, 2012 (20,000 stock options were granted in the three months ended June 30, 2011).

Warranty Provision Estimate

The company accrues for the estimated obligation under warranty provisions at the time sales are recognized and any changes in estimates are recognized prospectively.

Financial Instruments

The Company has classified its financial instruments as follows:

- Cash and cash equivalents and bank indebtedness, if any, as "held-for-trading"
- Trade accounts receivable and other amounts and due from related parties are classified as "loans and receivables"
- Accounts payable and accrued liabilities, amounts due to related parties and advances under credit facility 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. 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 Operations. 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 adoption of these standards did not have an impact on the classification and valuation of financial instruments.

CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION

Recently adopted accounting pronouncements:

International Financial Reporting Standards

The CICA's Accounting Standards Board announced that Canadian publicly accountable enterprises will adopt IFRS as issued by the International Accounting Standards Board effective January 1, 2011. The accompanying consolidated financial statements for both the three months ended June 30, 2012 and the year ended December 31, 2011 (including interim 2011 quarterly periods) have been prepared to reflect the Company's adoption of IFRS, with the effective date being fiscal year beginning January 1, 2011.

OUTLOOK, BUSINESS RISKS AND UNCERTAINTY

Sales Risks

In 2010 Photon Control saw a recovery in demand from the semiconductor market, resulting in sales to this market that more than doubled compared with fiscal 2009. The solid order trends and a sales order backlog continued during fiscal 2011 and during the first half of 2012, despite the semiconductor market fluctuations. Also, the Company endeavours to reduce the risk of key client dependence by continuing its initiative to diversify its product range and develop relationships with new distributors for products for the oil and gas, power, life science, and manufacturing industries.

Going-Concern Risk

The consolidated financial statements have been prepared by management on a going-concern basis which assumes the Company will continue in operation for the foreseeable future and will be able to realize its assets and settle its liabilities and commitments in the normal course of business. These financial statements do not reflect the adjustments to the carrying values of assets and liabilities and the reported expenses and balance sheet classifications that would be necessary should the going concern assumption become inappropriate.

Outlook, Market, Competition, and Foreign Exchange Risk

In 2011, Photon Control demonstrated the resilience of the Company's business and ability to generate revenue for the foreseeable future, sustaining solid financial results for the third consecutive year. Although the Company continues to be influenced by fluctuations in revenue as a result of volatility in the markets, product mix and the gross margin in 2012, Photon Control expects to maintain a solid level of orders in the current fiscal year. While there can be no assurance of the ability of the Company to penetrate target markets, the Company endeavours to limit the effects of risk factors, including the competition risks, through its strategic planning, management processes and marketing research. The Company continues to focus on securing consistent delivery of high quality and value-added products and services.

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 of the values of financial instruments. 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 dollars. As at June 30, 2012, the Company did not utilize any forward exchange contracts to mitigate any of the risks as mentioned above. Photon Control manages its exposure to foreign currency fluctuation by maintaining Canadian and United States dollar bank accounts to offset foreign currency payables and planned expenditures. As at June 30, 2012, the Company was not exposed to significant credit or interest rate risk.

OUTSTANDING SHARE DATA

As at June 30, 2012 and the date hereof, the Company had 102,909,518 common shares issued and outstanding. There were outstanding stock options to purchase an additional 3,420,000 common shares of the Company as at June 30, 2012 and remains unchanged as at the date hereof.

ADDITIONAL INFORMATION

Additional information and other publicly filed documents relating to the Company are available through the Canadian Securities Administrators' System for Electronic Document Analysis and Retrieval ("SEDAR") which can be accessed at www.sedar.com.