PHOTON CONTROL INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS

For the second quarter ended June 30, 2013

This Management's Discussion and Analysis ("MD&A") of Photon Control Inc. ("Photon Control" or the "Company") is dated August 21, 2013. This MD&A should be read in conjunction with the unaudited interim consolidated financial statements and accompanying notes for the period ended June 30, 2013, and the audited consolidated financial statements and accompanying notes as at and for the years ended December 31, 2012 and 2011.

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 six months ended June 30, 2013 and for the same period in the prior year 2012 have been prepared to reflect the Company's adoption of IFRS, with the effective date being fiscal year beginning January 1, 2011.

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 offers 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, British Columbia, Canada, Photon Control Inc. is listed on the TSX Venture Exchange (the "TSX V"), 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 three major capital equipment manufacturers 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, develop new technologies, and convert the Company's intellectual property (consisting of 20 issued and 5 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, 2013, Photon Control staff included 32 full-time personnel representing a modest increase of approximately 7%, compared to 30 full-time personnel at the end of Q2 2012. Subsequently, in order to fulfil the significant increase in sales order backlog, the Company contracted three employees in Q3 2013.

Photon Control's Board of Directors adopted a shareholder rights plan (the "Rights Plan") effective August 20, 2012, which was subsequently approved by Photon Control's shareholders and the TSX Venture Exchange. The Rights Plan is designed to maximize shareholder value and protect shareholders' interests in the event of a take-over bid that may result in a change of control of Photon Control. The Rights Plan will expire at the termination of Photon Control's annual general meeting in 2015, unless extended upon reconfirmation by shareholders at that meeting.

The TSX V has accepted the Company's notice of intention dated May 1, 2013 to make a normal course issuer bid (the "NCIB") for its common shares through the facilities of the TSX V. Photon Control may commence making purchases of up to a maximum of 5,000,000 common shares, which represents approximately 4.86% of the Company's 102,909,518 issued and outstanding common shares as at May 8, 2013. A purchase of common shares under the NCIB also may not, when aggregated with the total of any other purchases in the 30 days preceding the purchase, whether through the facilities of the TSX V or otherwise, exceed 2% of the total issued and outstanding common shares of the Company at the time the purchase is made. Canaccord Genuity Corp. will be conducting the NCIB on behalf of the Company. Any common shares acquired under the NCIB will be purchased at the market price. All shares acquired by the Company pursuant to the NCIB will be cancelled following purchase. The Company is conducting the NCIB to give it the flexibility to purchase its common shares if it determines that, as a result of the difference in the fundamental value of the common shares and the market price, it is in the best interests of the Company to do so. The normal course issuer bid will terminate on the earlier of the date determined by the Company and May 7, 2014.

CORPORATE VISION AND STRATEGY

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. However, Photon Control remains focused and fully committed to its core values and long-term growth strategy.

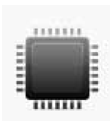
Some of Photon Control's key operational objectives are to:

- Continuously enhance manufacturing efficiency, capacity and agility in order to more proficiently meet customer trends and demands;
- Create efficient financial planning, maintain strong budget controls and adhere to strict inventory control procedures in order to quickly adapt to new and changing market conditions;
- Implement operating cost structures that align with overall revenue;
- Renegotiate contracts with vendors and suppliers to obtain more favourable terms;
- Expand distribution network to match strategic goals and to help achieve long-term business relationships; and
- Implement prudent measures that enhance revenue and capitalize on growth opportunities on a global scale, with initiatives to create demonstrable value for shareholders.

These activities remain important elements of Photon Control continuing liquidity management and organizational efficiency plan.

The Company is supplying 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 System for SAGD extraction processes in Oil Sands applications

Power & Energy:

- PowerTemp Series single-channel and multi-channel temperature measurement systems for monitoring of dry transformers, switchgear and power generators

Life Sciences:

- UV / VIS / NIR Spectrometers, Light Sources and Accessories
- Optical sensors (Life Science temperature measurement systems)

Institutional Research:

- 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)

SELECTED INTERIM FINANCIAL INFORMATION

The comparative figures for all fiscal periods conform with the presentation in accordance with IFRS adopted by the Company commencing with fiscal year beginning January 1, 2011.

	Six Months Ended June 30		
	2013	**2012**	**2011**
Total revenues	6,435,884	5,887,249	6,764,085
Income before discontinued operations and extraordinary items	1,134,743	1,214,280	832,855
Income per share before discontinued operations and extraordinary items, basic and diluted	0.01	0.01	0.01
Net income before taxes	1,134,743	1,214,280	832,855
Net income per share, basic and diluted	0.01	0.01	0.01
Total assets	15,809,745	12,360,363	7,471,645
Total long-term financial liabilities	—	—	353,542
Cash dividends declared per common share	—	—	—

SECOND QUARTER 2013

Highlights of Q2 2013

- Sales of $3.7 million (Q2 2012: $2.8 million)
- Operating Expenses of $0.9 million (Q2 2012: $0.5 million)
- Profit before taxes of $743,516 (Q2 2012: profit before taxes of $622,853)
- Gross Margin of 40% (Q2 2012: 37%)
- Sales Order Backlog of $3.3 million (Q2 2012: $1.5 million)

Sales

Photon Control's sales for the three months ended June 30, 2013 were $3.7 million, representing an increase of $0.9 million or approximately 32% compared with $2.8 million during the same period last year.

Expenses

General and administrative expenses totalled $541,639 in Q2 2013 compared to $349,112 in Q2 2012. This increase relates primarily to a $142,096 increase in the estimate of legal judgment including additional interest and court costs (see "Litigation" section below for more details).

Research and development expenses totalled $222,102 in Q2 2013 compared to $80,515 in Q2 2012. This increase is primarily due to a new engineering support standby fee for 2013 of $45,000 per month to ensure prompt technical response to customer requests, support for OEM and other customers, development of new product and engineering design, and to maintain technical competitiveness while exploring new market opportunities (see "Results of Operations and Q2 2013 Overview" section below for more details).

Business development and marketing expenses totalled $99,178 for Q2 2013. This amount, when compared to $41,767 in Q2 2012, reflects an addition of sales staff to take advantage of increased market opportunities plus an increase for trade shows in which the Company participated in the period.

Profit for the Period

Q2 2013 profit before taxes was $743,516, representing an increase of approximately 19% compared with a profit before taxes of $622,853 for the same period in 2012 (see "Net Earnings" and "Operating Expenses" sections below for more details).

RESULTS OF OPERATIONS AND Q2 2013 OVERVIEW

During 2013, Photon Control continued to identify and evaluate opportunities to enhance its operational results and to diversify its product range. The Company dedicated more efforts into assessing and analyzing the market for the purpose of improving the effectiveness of sales and further improve its capability to open new market opportunities and revenue streams.

In Q2 2013, Photon Control saw an improvement in sales, gross margins and profit results when compared to the same quarter in the prior year 2012. In Q2 2013, Photon Control recorded sales of $3.7 million, approximately 32% higher than sales in Q2 2012. Photon Control's net earnings before taxes for Q2 2013 were $743,516 as compared to net earnings before taxes of $622,853 for the same period in 2012. The achieved results in Q2 2013 reflect both a higher volume of orders of the semiconductor sector booked and reported during the current fiscal year 2013, and Company's enhanced operational efficiency.

Product sales for the six months ended June 30, 2013 were $6.4 million, representing an increase of approximately 9% compared to $5.9 million during the same period last year. The net profit for the six months ended June 30, 2013 was $1,134,743, approximately 7% lower compared to the net profit of $1,214,280 for the same period in 2012, mainly due to an increase of lawsuit provision of $270,000 but offset by higher foreign exchange of $208,446.

Although the revenues from the semiconductor industry have historically fluctuated from quarter to quarter, during the current fiscal year 2013 Photon Control's sales to this market were on an up cycle, supported by a steady flow of sales of non-semiconductor products. The Company is strategically focused on its ongoing efforts to add new non-semiconductor sources of revenue and continues to be in touch with potential business partners/distributors in this regard.

In 2013, Photon Control continues to develop new sensor technologies and customized products for existing OEM customers, and is further expanding its product lines to pursue new customers in other sectors. In addition, Photon Control continued to implement better communication procedures with existing distributors for increasing productivity and marketing initiatives. To this end, Photon Control has 18 active distribution agreements, however, performance measures through sales will require some time.

The Company's strategic decision to invest in sales resources, new product development and the engineering support to accelerate future growth is predominantly driven by these factors:

- to maintain strong customer relationships including having a technical team of engineers readily available to quickly and cost-effectively meet each customer's needs;
- to maintain a strong team working with the existing OEM accounts, tailored to support their unique needs in custom engineered projects;
- to maintain competitive edge and expand the Company's reach in increasingly complex OEM environment and the marketplace; and
- to refine the Company's strategy and ensure maximum awareness when introducing new or existing products while pursuing new channels and market opportunities.

During the current fiscal year 2013, Photon Control remains encouraged by improved volume of orders compared to the previous year. As of the day of this report, the Company's sales order backlog stood at $3.7 million.

In addition, the Company continues to analyze and monitor industry trends and customer needs in order to ensure proper budgeting, supported by cost management and operational efficiency programs.

In 2012, the bank operating line of credit facility was increased from $500,000 to maximum of $1,000,000. As at June 30, 2013, the bank line of credit was not utilized due to the increase in cash flow from operations and currently remains available for use if needed.

MARKETING AND RECENT DEVELOPMENTS

Commercialized Products and Business Trends

Worldwide Distributor Locations

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 2013, Photon Control participated in the Laser World of Photonics trade exhibition in Munich, Germany along with Photonics North in Ottawa. The Company presented its Spectrometer product line, unveiled the new Specsoft Pro software, Optical Temperature Sensors and promoted its OEM manufacturing capabilities. In addition, Photon Control met with distributors at the trade exhibition to identify and discuss new market opportunities and expansion strategies. Photon Control also participated in the Gas & Oil Conference in Calgary, Alberta. The company displayed the FOCUS® Optical Flow Meter and presented a paper on the technology of the FOCUS® Optical Flow Meter.

Photon Control continued to develop the Sales & Marketing initiatives by expanding the Company's on-line presence by: producing product demo videos, establishing email campaigns for a targeted demographic, and implementing various social media platforms such as Facebook, Twitter, LinkedIn and YouTube. The Company has also focused on building stronger relationships with their worldwide distribution network and building direct sales with local universities, labs and research facilities.

Product Sales and Operational Update

Product sales in Q2 2013 were $3.7 million, representing an increase of approximately 32% compared to $2.8 million during the same period last year. This increase in sales over the same period last year is mainly due to increased market activity. During 2013, the Company continued to experience a stable volume of orders from the semiconductor sector. In addition, the continued inflow of orders from the non-semiconductor sector included the sales of analytical products, flare gas meters, optical temperature sensors and spectrometers.

Gross Margin

The gross margin percentage for Q2 2013 of 40% increased from the Q2 2012 gross margin percentage of 37%. The increase of gross margin during Q2 2013 was primarily due to a increase in overall revenue, sales of more favourable margin products, an increase in foreign exchange gains due to a stronger U.S. dollar as well as continuing cost reduction measures.

Operating Expenses

General and administrative expenses totalled $541,639 in Q2 2013 compared to $349,112 Q2 2012 due to an increase in:

- salaries/financial services $ 40,351
- non-directors' stock option expense $ 2,850
- directors' stock option expense $ 6,800
- audit $ 2,595
- legal fees $ 13,467
- lawsuit provision adjustment $ 142,096
- other expenses $ 9,368

and offset by a decrease in:

- rent and office premises expenses $ 1,977
- supplies and postage $ 3,416
- insurance $ 10,081
- depreciation $ 2,933
- travel $ 1,295
- communications $ 5,297

Research and development expenses totalled $222,102 in Q2 2013 compared to $80,515 in Q2 2012 primarily due to increase in:

- monthly engineering support fees $ 135,000 (new charge for 2013)
- certification and testing $ 20,164

and offset by a decrease in:

- staff reduction $ 1,439
- consulting expenses $ 9,313
- depreciation $ 2,211
- other expenses $ 614

Business development and marketing expenses totalled $99,178 in Q2 2013 compared to $41,767 in Q2 2012 primarily due to an increase in:

- additional inside sales staff $ 22,642
- trade shows $ 31,584
- promotion $ 1,291
- travel expenses $ 1,894

Other Expenses

Photon Control's products are priced in U.S. dollars. Fluctuations in the value of the U.S. dollar through 2013 and 2012 resulted in a foreign exchange gain of $122,626 in Q2 2013 compared to a foreign exchange gain of $44,725 in Q2 2012.

Net Earnings

The net earnings before taxes for Q2 2013 were $743,516 compared to net earnings of $622,853 in Q2 2012. This $120,663 increase in earnings was primarily attributable to:

- $429,938 increase in Gross Margin (due to both a mix of sales of product with more favourable margins in Q2 2013 combined with a 32% increase in Q2 2013 revenue compared to Q2 2012)
- $82,250 increase in Other Earnings (mainly foreign exchange gains)

and offset by:

- $391,525 increases in Operating Expenses (primarily caused by increases in both new engineering support fees of $135,000) plus an increase in General and Administrative Expenses (primarily due to an increase in the lawsuit provision of $142,096) as well as an increase in Business Development trade shows expenses.

CORPORATE TAXES

Corporate taxes recognized for Q2 2013 were $ Nil (Q2 2012 – $ Nil).

As at June 30, 2013, the Company had a deferred tax asset of $5,303,841. A tax recovery of $1,376,953 for FY2012 and $3,926,888 for FY2011 was recognized for unused loss carry forwards, deductable scientific research and development credits and the effects of changes in income tax rates. In fiscal years prior to 2011, there was some doubt if Photon Control could ever utilize these loss carry forwards before they expire, consequently this item was not recognized. However, the Company's recent history of profitability from 2009 to 2012 has removed this concern.

ORDER BACKLOG

The second quarter of 2013 continued to demonstrate a solid sales order backlog. At June 30, 2013, Photon Control's sales order backlog stood at $3.3 million. This represents the value of sales orders already fulfilled in Q3 2013 and/or waiting to be fulfilled in 2013.

SUMMARY OF QUARTERLY RESULTS

The following table is a summary of Photon Control's financial results for the past eight quarters. The comparative figures for all fiscal quarters below conform with the presentation in accordance with IFRS adopted by the Company commencing with fiscal year beginning January 1, 2011.

	June 30, 2013	March 31, 2013	December 31, 2012	September 30, 2012	June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2011
Revenue	$ 3,651,744	$ 2,784,140	$ 2,108,519	$ 2,372,511	$ 2,815,522	$ 3,071,727	$ 1,981,770	$ 2,740,028
Net income / loss before taxes	$ 743,516	$ 391,227	$ 136,011	$ 309,524	$ 622,853	$ 591,427	$ (516,957)	$ 404,836
Net income / loss per share Basic & Diluted	$ 0.01	$ 0.00	$ 0.00	$ 0.00	$ 0.01	$ 0.01	$ (0.01)	$ 0.01

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents at June 30, 2013 had a balance of $3,872,033 compared to $1,666,553 as at June 30, 2012. The Company had working capital of $6,592,836 as at June 30, 2013 compared to working capital of $4,762,787 as at June 30, 2012. The increase in cash levels as at June 30, 2013 resulted from continued improvements in reducing the collection time of receivables and significant decrease in inventory levels. Working capital increased due to a reduction of both liabilities and inventory plus the increase in cash.

Cash provided by operations totalled $268,636 for the six months ended June 30, 2013 compared to $657,130 cash provided by operations in the six months ended June 30, 2012. Investing activities used cash of $4,110 for the six months ended June 30, 2013 compared to $15,685 for the six months ended June 30, 2012. Cash used in financing activities was $nil in 2013 compared to $nil in 2012.

As at June 30, 2013, the Company's accounts payable and accrued liabilities, which fall due for payment within 12 months of the balance sheet date, were $749,046 compared to $809,178 as at June 30, 2012.

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.

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 2012 and the current fiscal year 2013 form the basis of management's opinion that the Company will meet its liabilities and commitments as they become due. The Company is currently monitoring all expenditures and implementing cash management strategies to ensure that it has adequate cash reserves to fund identified expenditure requirements.

In 2012, the Company was successful in increasing its line of credit to $1,000,000 (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 from June 30, 2013 as follows:

2013	329,463
2014	701,044
2015	743,281
2016	785,643
	$ 2,559,431

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 Company's News Release dated August 2, 2011, the Supreme Court of British Columbia decided 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 Company's News Release dated September 12, 2011, Photon Control filed a Notice of Appeal from the decision of the Supreme Court of British Columbia in respect of 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 Company's News Release dated August 16, 2012, the Court of Appeal dismissed the Company's appeal and upheld the trial decision. As announced in the Company's News Release dated June 12, 2013, the Supreme Court of Canada has denied the Company's application for leave to appeal the decision of the British Columbia Court of Appeal.

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. Also, the Company recorded an additional $539,501 in Q1 2012 to reflect the decision of the Court and the current estimate of this claim. Both of these amounts, totalling $850,000, were classified in Q1 2012 as a contingent liability. 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). An additional $142,096 was added to the provision in Q2 2013 resulting in a total provision of $992,096 as at June 30, 2013.

Subsequently, in Q3 2013, the Company proceeded with payments to Claimant. Appropriate adjustments will be made in the Company's future 2013 financial statements to reflect the decision of the Court (see the Company's Q2 2013 unaudited interim consolidated financial statements "Litigation" section for more details).

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 and DCD Management Ltd. Photon Control R&D Ltd. commenced providing engineering consulting and research and development services to the Company on October 1, 2008 and, as a result, the Company has reduced its internal research and development operations.

The Company subleases space to Photon Control R&D Ltd. and DCD Management Ltd. at the same facility. The Company charges Photon Control R&D Ltd. and DCD Management Ltd. premises and related expenses to recover the Company's costs. The Company charges Photon Control R&D Ltd. and DCD Management Ltd. premises and related expenses to recover the Company's costs. Amounts outstanding with Photon Control R&D Ltd. and DCD Management Ltd. are non-interest bearing, unsecured and due on demand. (See "Subsequent Events" section below for more details). These accounts are active and payments are received on a monthly basis, and the balance is paid out at least twice during the year.

Years ended June 30	2013	2012
Balance Sheet:		
Accounts receivable	$ 1,313,321	$ 798,938
Note receivable	157,702	178,224
Accounts payable	415,483	97,056
Statement of Operations:		
Recovery of premises and related expenses	153,178	107,907
Payroll re-imbursement	734,094	665,229
Engineering, research and development services	412,568	163,484
Royalties	302,600	201,569
Revenue from sales of products and services	145,306	61,792
Management services (includes accounting, payroll, IT)	93,438	67,685

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

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

In Q3 2013, outstanding balances with Photon Control R&D Ltd. have been changed to interest bearing from current non-interest bearing (See "Related Party Transactions" section above).

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 second quarter June 30, 2013. 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 2013 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. The amount amortized in Q2 2013 was $nil (Q2 2012 - $nil). Commercial production is expected to commence in the current fiscal year. The Company has a June 30, 2013 balance of $148,824, (2012 - $150,616) of deferred development expenses. As at June 30, 2013, these deferred development 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.

No stock options were granted during the three months ended June 30, 2013 (30,000 stock options were granted in the three months ended June 30, 2012).

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”; and
- 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 are to adopt IFRS as issued by the International Accounting Standards Board effective January 1, 2011. The consolidated financial statements of the Company for both the second quarter June 30, 2013 and for the previous second quarter June 30, 2011 have been prepared to reflect the Company's adoption of IFRS, with the effective date being the fiscal year beginning January 1, 2011.

OUTLOOK, BUSINESS RISKS AND UNCERTAINTY

Sales Risks

The stable order trends and a sales order backlog continued over the last four years, including the current fiscal year 2013, despite semiconductor market fluctuations and difficulties in global economy recovery. 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

Since 2009, Photon Control has demonstrated the resilience of the Company's business and ability to generate revenue for the foreseeable future, sustaining positive financial results for the last four years including the second quarter of its 2013 fiscal year. Although the Company continues to be influenced by fluctuations in revenue as a result of volatility in the markets and product mix, Photon Control expects to maintain a stable level of orders and feels that the efforts made over the past couple of years have created a positive start to 2013.

Although there can be no assurance of the ability of the Company to penetrate target markets in 2013 while constantly facing new challenges and opportunities, Photon Control endeavours to limit the effects of risk factors, including competition risks, through its strategic planning, management processes and marketing research. Moreover, the Company continues to focus on improving the quality and efficiency of its operations and development, while 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 or 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, 2013, 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, 2013, the Company was not exposed to significant credit or interest rate risk.

OUTSTANDING SHARE DATA

As at June 30, 2013 and the date hereof, the Company had 102,909,518 common shares issued and outstanding. There were outstanding stock options to purchase an additional 5,500,000 common shares of the Company as at June 30, 2013 which 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.

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