# PHOTON CONTROL INC.

## MANAGEMENT DISCUSSION AND ANALYSIS

For the third quarter ending September 30, 2009

# MANAGEMENT DISCUSSION AND ANALYSIS

This Management Discussion and Analysis ("MD&A") is dated November 26, 2009.

## Forward-Looking Statements

This Management's Discussion and Analysis ("MD&A") contains forward-looking statements about Photon Control Inc. (the "Company") and its business. Forward-looking statements are statements that are not historical facts and are generally, but not always, identified by the words "expects," "anticipates," "believes," "intends," "estimates," "projects" and similar expressions, or that events or conditions "will," "may," "could" or "should" occur.

The forward-looking statements in this MD&A are subject to various risks, uncertainties and other factors that could cause the Company's actual results or achievements to differ materially from those expressed in or implied by forward-looking statements. These risks, uncertainties and other factors include, without limitation, uncertainty as to the Company's ability to successfully complete new product development 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 for nearly all its sales; the accuracy and reliability of the factors and assumptions of the Company listed above; the development of competing technologies and the possibility of increased competition; the effect of slow growth in the Canadian, United States and international economies generally and other economic trends and conditions in the markets that the Company and its customers serve; the effect of the risks associated with technical difficulties or delays in product introductions, improvements, implementation, product development, 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, the possibility that the Company will pursue additional development projects or 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. Precautionary statements made herein should be read as being applicable to all related forward-looking statements wherever they appear in this MD&A. Readers are encouraged to consider the other risks and uncertainties discussed in the Company's required financial statements and filings.

## Approval

The Board of Directors of the Company has approved the disclosure contained in this MD&A.

# PHOTON CONTROL INC.

For the third quarter ending September 30, 2009
(Prepared by management)

## FINANCIAL HIGHLIGHTS

- Q309 Sales $1.5 million compared to Q308 Sales of $1.1 million
- Q309 Operating Expenses $0.3 million, compared to $0.4 million for Q308
- Q309 Profit $0.34 million, compared to Q308 Profit $0.04 million
- Q309 Gross Margin 46%, compared to 41% for Q308
- Q309 Order Backlog $2.6 million, compared to $0.8 million for Q308

During the third quarter of 2009, Photon achieved strong sales and profit growth, making Q309 its most profitable quarter ever. Despite a slow start to the year and general slowdown in the economy, Photon's product sales rose substantially in the third quarter. The diversity of Photon's product offering, and continued streamlining of operations, allowed it to successfully mitigate the impact of challenging economic conditions.

As anticipated, increased orders and revenues from Photon's semiconductor base contributed significantly to Q309 results, which was consistent with both recovery and rise in activity signals experienced in the semiconductor sector. The third quarter was also impacted by significant increase in Photon's order backlog, which reached a new record level and represents the total value of sales orders waiting to be fulfilled.

Operating results improved in each of Photon's business segments including the strengthening of customer relationships and customer base growth. Photon is taking additional steps to improve its operational efficiency in order to maintain consistent delivery of high quality and value-added services to its customers.

As at September 30, 2009 the Company's $500,000 bank line of credit was fully utilized. As at the date of this report, Photon's Order Backlog stood at $2.8 million. This represents the total value of sales orders to be fulfilled, of which $1.5 million is expected to be completed by year-end.

## PRODUCT SALES

During Q309 Photon achieved substantial sales and profit increase of $1.5 million and $0.35 million respectively. Third quarter sales increased 36% over Q308 while Q309 profit increased by $0.31 million compared to Q308. Photon's sales to semiconductor market continued to improve from quarter to quarter and also doubled compared to Q209.

Photon received its first volume purchase order from Russia for its flow meter products, as well as volume sales of its low cost fiber optic temperature sensor targeting the power industry. In addition, Photon entered an agreement to supply a new jet fuel analytical instrument with initial orders scheduled for Q409.

## MARKETING

Photon has broad geographic representation with dedicated distributors in North America, Europe and Asia. In Q309 Photon continued to evaluate new opportunities by focussing on marketing and business development and addressing both the current and future demands of the market. In line with this objective, Photon is actively seeking distributors for its temperature sensor, spectrometer and flare meter product lines in key International markets. As well, Photon is continuing to penetrate the Asian market with its low-cost fiber optic temperature sensor product.

## BUSINESS DESCRIPTION

Photon Control Inc. is a public company listed on the Canadian TSX Venture Exchange (TSX-V) under the symbol PHO. At September 30, 2009, Photon staff included 22 full-time personnel.

Photon commercializes innovative optical sensor systems capable of use by customers in a variety of sectors. Photon's approach to creating shareholder value has been to pursue Original Equipment Manufacturer (OEM) sales whether directly or through a distributor and to investigate the market potential of products by working directly with customers in selected industries to foresee their sectors' requirements. These collaborations often include commitments to conduct trials of the new products in industrial sites.

While focusing on production and marketing of high-quality products, Photon established a strong business relationship with an engineering and R&D company, Photon Control R&D Ltd, for the purpose of converting Photon's accumulated wealth of Intellectual Property into commercial products.

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

Currently Photon supplies products to its 'Fortune 500' customer 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.

## 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 sensing solutions (sensors for positioning, spacing, detection, and related controls, robot alignment and positioning jigs, analytical tools for inspection of silicon wafers) or Silicone Wafer Sensing Spectrometers<br>Fiber optic temperature sensors |

| | |
|---|---|
| Oil, Gas & Petrochemical: | Optical flow meters for measurement of stack emissions (greenhouse gases, flares), fuel gas, associated gas, coal bed methane, biogas<br>Total sulphur analyser for measurement of total sulphur content in diesel, gasoline, kerosene, jet fuel and other processed hydrocarbons<br>Fiber optic temperature and pressure sensors for down-hole monitoring for steam-assisted gravity drainage (SAGD) |
| Power & Energy: | Temperature Sensor Systems |
| Life Sciences: | Spectrometers<br>Fiber Optic Temperature Sensors |
| Institutional: | Spectrometers<br>Fiber Optic Temperature Sensors<br>fMRI Response (LUMItouch®) |
| Food and Drug: | Spectrometers |

## SUBSEQUENT EVENTS

As at November 26, 2009, Photon's Order Backlog stood at $2.8 million, compared to $2.6 million for Q309. In order to fulfil this significant increase in sales order backlog, and in addition to returning to a five-day work week in Q209, Photon staff include 27 full-time personnel.

As announced in the News Release dated October 7, 2009, Photon appointed Christopher Weston as President of the Company. In his role, Christopher assumed a principal leadership role for the execution of Photon's overall business. Also, Photon announced that Mr. Michael Weston left his role as Interim President and has resigned as member of the Board.

## ANNUAL GENERAL MEETING

Photon will be holding its annual general meeting on December 3, 2009, at 2:00 pm, at the head office of Photon Control Inc., Suite 200 – 8363 Lougheed Highway, Burnaby, British Columbia.

# PHOTON CONTROL INC.

For the third quarter ending September 30, 2009
(Prepared by management)

## FINANCIAL OPERATIONS

*For the quarter ended September 30, 2009 (“Q309”) compared to the quarter ended September 30, 2008 (“Q308”). Certain of the comparative figures have been reclassified to conform with the presentation adopted for the current year.*

**Summary Of Quarterly Results**

| | September 30, 2009 | June 30, 2009 | March 31, 2009 | December 31, 2008 | September 30, 2008 | June 30, 2008 | March 31, 2008 | December 31, 2007 |
|---|---|---|---|---|---|---|---|---|
| Revenue | $ 1,489,914 | $ 683,971 | $ 635,889 | $ 1,420,234 | $ 1,058,453 | $ 1,519,366 | 1,352,327 | 1,489,238 |
| Net income / loss | $ 343,340 | $ (191,064) | $ (160,592) | $ 37,332 | $ 37,793 | $ (520,553) | $ (677,976) | $ (483,737) |
| Net income / loss per share | $ 0.00 | $ (0.00) | $ (0.00) | $ 0.00 | $ 0.00 | $ (0.01) | $ (0.01) | $ (0.01) |

### Revenue

Revenue for Q309 totalled $1,489,914 as compared to $1,058,453 in Q308. The backlog of secured work was $2.648 million at the end of Q309. The backlog of secured work was $0.8 million at the end of Q308.

### Gross Margin

The gross margin percentage for Q309 was 46% compared to a Q308 gross margin of 41%.

### Expenses

General and administrative expenses totalled $236,593 in Q309 as compared to $229,771in Q308. This shows the levelling off in salaries, premises, and insurance expense.

Engineering expenses totalled $-21,352 in Q309 as compared to $75,116 in Q308. The credit reflects a review of a project which was properly allocated to Photon’s outsourced engineering company.

Business development and marketing expenses were $34,058 in Q309 compared to $40,024 in Q308. These costs should remain relatively stable.

#### Profit for the Period

The profit for Q309 was $343,340 as compared to a profit of $37,793 in Q308. This is due to an increase in gross margin of $251,434 as well as a decrease in operating costs of $100,840.

### Liquidity and Solvency

Cash and cash equivalents as at September 30, 2009 totalled $0 compared to $0 as at September 30, 2008. The Company had working capital of $811,868 as at September 30, 2009 compared to working capital of 415,055 as at September 30, 2008. This increase in working capital has resulted from the continued provision of cash for operations as detailed below.

Cash provided in operations totalled $64,867 in Q309 as compared to a use of $115,489 in Q308. Investing activities used cash of $12,195 in Q309 as compared to $14,215 in Q308. Cash used by financing activities was $52,671 in Q309 relating to the Company’s credit facility.

As at September 30, 2009, the Company's accounts payable and accrued liabilities were $984,609 of which all fall due for payment within twelve months of the balance sheet date. As at September 30, 2009, the Company was using $481,120 of its $500,000 credit facility.

The Company's quarterly high and low share prices and average daily trading volumes during the last four quarters were as follows:

| Share Price | | | Avg Daily Volume |
|---|---|---|---|
| | High | Low | |
| Q408 | $0.06 | $0.01 | 235173 |
| Q109 | $0.03 | $0.01 | 41184 |
| Q209 | $0.02 | $0.01 | 40920 |
| Q309 | $0.03 | $0.01 | 54354 |

The Company's future operations are dependent upon the market's acceptance of its products in order to ultimately generate future profitable operations, and the Company's ability to secure sufficient financing to fund future operations. There can be no assurance that the Company's new products will be able to secure market acceptance. Management is in the process of exploring financing options to secure the near term financing needs of the Company.

## 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 period ended September 30, 2009. The measurement of certain assets and liabilities is dependent upon future events whose outcome 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 a weighted average 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 rates. 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.

*Engineering Costs*

Engineering costs are expensed as incurred. The Company has a balance of $201,545 of deferred development expenses, incurred in 2008 and unchanged at September 30, 2009.

*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

*Goodwill and Intangible Assets*

In February 2008, the CICA issued new CICA 3064, Goodwill and Intangible Assets, replacing CICA 3062, Goodwill and Other Intangible Assets, and CICA 3450, Research and Development Costs. Collectively, these changes bring Canadian practice closer to International Financial Reporting Standards (“IFRS”) and U.S. GAAP.

## OUTLOOK, BUSINESS RISKS AND UNCERTAINTY

*Sales Risks*

Customers in the Company’s semi-conductor market had reduced / postponed orders as a consequence of a reduction of demand in their markets. However in Q209 and Q309 Photon’s sales to semiconductor market increased significantly as compared to Q109 and 2008. It is unforeseeable to what extent this postponement of sales orders will translate into a longer term recovery of revenue from this segment. Uncertainties in the semiconductor markets, customer order volatility and changes in their budgets impact Photon’s liquidity. Photon endeavours to reduce the risk of key client dependence by continuing to diversify its product offering and growth in independent markets.

*Foreign Exchange Risk*

Photon's products are marketed internationally and are priced in U.S. dollars, which exposes the Company to U.S. and other foreign currency fluctuation risk. Photon manages its exposure to foreign currency fluctuation by maintaining Canadian and U.S. bank accounts to offset foreign currency payables and planned expenditures. As at September 30, 2009, the Company did not utilize any forward exchange contracts to mitigate any of the risks as mentioned above.

*Going Concern Risk*

Photon, like many other companies, faces a number of challenges and uncertainties in addition to normal business and operating risks. As part of ongoing efforts to dampen the influence of the global economic slowdown conditions, Photon restructured its Research and Development operations. In 2009 Photon continues to investigate strategic marketing opportunities and intends to leverage its industry expertise and to make prudent spending decisions in order to preserve long-term value.

The ability of the Company to meet its financial obligations as they fall due depends on the Company being able to continue to secure external financing as well as the timely collection of its outstanding trade accounts receivable. As at September 30, 2009, the Company's accounts payable and accrued liabilities were $984,609 of which fall due for payment within twelve months of the balance sheet date. As at September 30, 2009, the Company was using $481,120 of its $500,000 credit facility.

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.

*Market 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 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's may be subject to, material, realized and unrealized exchange gains or losses resulting from above average changes in exchange rates between the Canadian and United States dollar. As at September 30, 2009 the Company did not utilize any forward exchange contracts to mitigate the risks as outlined above.

**Other**

As at September 30, 2009 the Company has 101,752,018 common shares issued and outstanding. In addition there are outstanding stock options to purchase an additional 4,545,000 common shares.

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