# PHOTON CONTROL INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

For the year ended December 31, 2010

This Management's Discussion and Analysis ("MD&A") of Photon Control Inc. (the "Company" or "Photon") is dated April 20, 2011. MD&A should be read in conjunction with the Audited Consolidated Financial Statements and accompanying notes as at and for the years ended December 31, 2010 and 2009.

**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 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 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; and the possibility that the Company will pursue 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. is a British Columbia company listed on the TSX Venture Exchange (TSX-V) under the symbol PHO. Photon Control is a leading developer of innovative measurement technologies for use in Semiconductor, Oil & Gas, Power, Medical & Manufacturing industries to name a few. Photon Control operates a world class ISO 9001:2008 manufacturing facility where it specializes in custom engineered solutions for customers covering rapid prototyping to full scale mass production.

Photon Control's approach to creating shareholder value has been to pursue Original Equipment Manufacturer (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.

Currently 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 R&D company to which the Company had transferred its research and development division as of October 2008 for the purpose of converting the Company's intellectual property (consisting of 12 issued and 10 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. Reflective of strong order levels, as at December 31, 2010 Photon Control staff included 32 full-time personnel, representing a modest increase of 15% compared to 28 full-time personnel at the end of 2009.

## 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<br>• 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 during SAGD extraction process |
| Power & Energy: | • Temperature Sensor Systems for monitoring of transformers, switchgear and power generators |
| Life Sciences: | • Spectrometers<br>• Fiber Optic Temperature Sensors |
| Institutional: | • Spectrometers<br>• Fiber Optic Temperature Sensors |
| Food and Drug: | • Spectrometers |

## MARKETING

Photon Control has broad geographic representation with dedicated distributors in North America, Europe and Asia. 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 Q4 2010, 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. In light of this objective, the Company actively participated in International tradeshows and industry events attending Wind Energy Operations and Maintenance Conference in Madrid, Spain in November 2010, and POWER-GEN International conference in Orlando, Florida in December 2010, to further explore the power sector.

During 2010 Photon Control continued to strengthen its existing relationships and actively seek new distributors for its temperature sensor, spectrometer and flare meter product lines in key International markets. In 2010, Photon Control signed 2 additional distributorship agreements for spectrometers and temperature sensors, and implemented communication procedures with existing distributors for increasing productivity. All these activities validate the Company's expanded sales and marketing efforts. Along with seeking new distributors and further research for business development, Photon Control continued to expand marketing initiatives, by developing new marketing collateral and procedures to help strengthen and open communication channels with existing and potential customers.

## CORPORATE VISION AND STRATEGY

Although economic and market uncertainties, including a number of challenges such as order timing and volatility, required Photon Control and its customers to reposition its business plans over 2009 and 2010, 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 increased customer demands;
- Implement operating cost structures that align with revenue growth;
- 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 2011.

## SELECTED ANNUAL INFORMATION

Certain of the comparative figures in the following table have been reclassified to conform with the presentation adopted for 2010.

| | Year ended December 31 | | |
|---|---|---|---|
| | 2010 | 2009 | 2008 |
| Total Revenues | 13,414,270 | 5,387,710 | 5,350,378 |
| Income (loss) before discontinued operations and extraordinary items | 2,715,937 | 184,726 | (1,123,404) |
| Income (loss) per share before discontinued operations and extraordinary items, Basic and diluted | 0.03 | 0.00 | (0.01) |
| Net income (loss) | 2,715,937 | 184,726 | (1,123,404) |
| Net income (loss) per share, Basic and diluted | 0.03 | 0.00 | (0.01) |
| Total assets | 6,565,199 | 4,510,690 | 3,716,495 |
| Total long-term financial liabilities | 386,623 | 441,864 | 516,966 |
| Cash dividends declared per Common Share | — | — | — |

## FOURTH QUARTER 2010

### Highlights

- Q4 2010 Sales of $2.9 million compared to Q4 2009 Sales of $2.6 million
- Q4 2010 Operating Expenses of $1.4 million compared to Q4 2009 of $0.5 million
- Q4 2010 Profit of $172,947 compared to Q4 2009 Profit of $193,046
- Q4 2010 Gross Margin of 43% compared to 29% for Q4 2009
- Q4 2010 Order Backlog of $2.0 million compared to $3.5 million for Q4 2009

### Sales

During Q4 2010, Photon Control achieved solid sales and profit results for the quarter. Q4 2010 sales were $2.9 million compared to $2.6 million in Q4 2009, an increase of $0.3 million or 12%, representing 22% of the total year's revenue.

### Expenses

General and administrative expenses totalled $1,066,835 in Q4 2010 compared to $238,696 in Q4 2009. This reflects the increase in salaries and other expenses, including accounting and finance department services, of $788,147 due to the increase of business as well as an increase of $57,277 in legal costs.

Research and development expenses totalled $149,974 in Q4 2010 compared to $271,230 in Q4 2009. This reflects a reduction in salaries, materials and premises expenses due to the separation of research and development services from Photon Control.

Business development and marketing expenses totalled $127,702 for Q4 2010. This increase of $102,262 when compared to Q4 2009 of $25,439 reflects the expansion of the marketing department and its activities including the cost of trade shows participations during Q4 2010.

### Profit for the Period

The profit for Q4 2010 was $172,947 representing a decrease of approximately 10% compared to Q4 2009 mainly due to the increase in services and fees in Q4 2010**.**

## RESULTS OF OPERATIONS

In 2007 and 2008, Photon Control's product sales were at the lower volumes than expected primarily due to the deepening slowdown of the worldwide semiconductor industry, reduction in sales to one of the Company's major accounts and the global economic conditions. During 2007, this was partially offset by Photon Control's initiatives to reduce its operating expenses through selective reduction of personnel and R&D expenditures.

In 2008, Photon Control continued to align its spending levels to the Company's revenue outlook through a number of permanent and temporary actions ranging from lean manufacturing, stricter capital allocation and diversification of its product range. Additional cost savings in 2008 derived from the reduction of Photon Control's in house research and development department. As a result of Photon Control's efforts to improve on its performance and growth potential, the Company achieved break-even financial results through the second half of 2008.

In 2009, Photon Control's focus on prudent operational structure, diversification, and quality of customer relationships was intended to secure consistent delivery of high quality and value-added services to its customers, to enhance revenue diversification and open new market opportunities, and to develop a business and marketing alliance with new partners and distributors. Additional cost savings were derived from the reduction of salary expenses by approximately 20% through participation in the work-sharing program which is part of the employment insurance program under Human Resources and Skills Development Canada. Despite a slow start to the year and general slowdown in the economy during 2009, Photon Control achieved strong sales and profit growth during the second half of the year, making 2009 the first profitable year in Photon Control's history.

### 2010 Overview

In 2010, Photon Control saw an encouraging start to the year which resulted in strong sales and revenue growth, and sustained profitability throughout this period. In addition, Photon Control took decisive actions to enhance lean manufacturing, operational efficiency and risk mitigation process by implementing pro-active management of operations and financial planning.

During the first half of 2010, Photon Control's product sales rose substantially contributing to strong performance, record sales and earnings during the six months period, surpassing sales volumes for all of 2009. As anticipated, the second half of 2010 continued to report a strong sales revenue enabling Photon Control to achieve the record annual sales figures of $13.4 million. These results were mainly attributed to an improved economic environment including the rebound in the semiconductor sector, supported by steady flow of non-semiconductor order activity, and in combination with Photon Control's established cost management and operational efficiency programs.

As at December 31, 2010 the Company's $500,000 bank line of credit was not utilized due to the increase in cash flow from operations however, 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.

**Product Sales and Operational Update**

Product sales in fiscal 2010 were $13.4 million compared to $5.4 million in 2009, an increase of 150% and greater than any previous annual sales figures reported by Photon Control.

In 2010, Photon Control's sales to the semiconductor sector have more than doubled compared to last year and contributed significantly to the annual and Q4 2010 financial results, reflecting the improved conditions in this market. Also, Photon Control continued initiatives to diversify its product range and to develop relationships with new distributors for its product lines in all other industries that it serves. In line with these objectives, during 2010 Photon Control continued to grow revenues in other sectors which included the sale of analytical products, flare gas meters and fibre optic temperature sensors, representing an increase of approximately 40% over 2009 non-semiconductor sales.

**Gross Margin**

The gross margin percentage for 2010 of 43% increased from the 2009 gross margin percentage of 38%. The improvements in gross margin during 2010 were primarily due to an increase in sales of more favourable margin products and the strategic purchasing of components and material.

**Operating Expenses**

General and administrative expenses totalled $1,657,257 in 2010 compared to $882,245 in 2009.
General and administrative expenses increased through:

- salaries of $393,318
- insurance expenses of $76,883
- legal and accounting of $263,955
- office expenses of $89,469
- directors fees of $103,844 (stock option compensation expense)

and offset by a decrease in:

- investor relations of $15,090
- other expenses of $137,369.

Research and development expenses totalled $717,386 in 2010 compared to $613,450 in 2009 primarily due to and increase in consulting fees of $226,056 and offset by reduced salaries and other expenses of $122,120.

Business development and marketing expenses totalled $275,034 in 2010 compared to $130,690 in 2009 due primarily to increases in:

- salaries of $60,544
- other expenses of $5,168
- promotional expenses of $83,241

and offset by a decrease in:

- consulting fees of $2,040
- travel expenses of $2,569.

### Other Expenses

Photon Control's products are priced in U.S. dollars. A continuing and substantial weakening of U.S. dollar through 2009 and 2010 resulted in a foreign exchange loss of $174,922 in 2010 compared to a foreign exchange loss of $70,702 in 2009.

### Net Earnings

The net earnings for 2010 were $2,715,933 compared to net earnings of $184,726 in 2009. This improvement in operating results was attributable to an increase in revenues of $8,026,560 in 2010 offset by operating and other cost increases of $5,495,349.

## ORDER BACKLOG

The fourth quarter of 2010 continued to report a strong order backlog. At December 31, 2010 Photon Control's backlog stood at $2.0 million. This represents the value of sales orders already fulfilled in Q1 2011 and/or waiting to be fulfilled in 2011. As at the date of this report, Photon Control's order backlog stood at $2.8 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.

| | December 31, 2010 | September 30, 2010 | June 30, 2010 | March 31, 2010 | December 31, 2009 | September 30, 2009 | June 30, 2009 | March 31, 2009 |
|---|---|---|---|---|---|---|---|---|
| Revenue | $ 2,890,493 | $ 3,009,302 | $ 3,894,048 | $ 3,620,427 | $ 2,577,936 | $ 1,489,914 | $ 683,971 | $ 635,889 |
| Net income / loss | $ 172,947 | $ 639,182 | $ 1,009,656 | $ 894,158 | $ 193,046 | $ 343,340 | $ (191,064) | $ (160,592) |
| Net income / loss per share Basic & Diluted | $ 0.00 | $ 0.01 | $ 0.01 | $ 0.01 | $ 0.00 | $ 0.00 | $ (0.00) | $ (0.00) |

## LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents at December 31, 2010 had a balance of $933,503 compared to $12,955 as at December 31, 2009. The Company had working capital of $3,734,751 as at December 31, 2010 compared to working capital of $812,039 as at December 31, 2009. This increase in both cash and working capital has resulted from continued revenue growth.

Cash provided by operations totalled $1,511,999 in 2010 compared cash used by operations of ($246,093) in 2009. Investing activities used cash of $128,021 in 2010 compared to $61,995 in 2009. Cash used in financing activities were $463,430 compared to $212,461 in 2009 relating to the Company's credit facility.

As at December 31, 2010, the Company's accounts payable and accrued liabilities was $1,078,752 which fall due for payment within twelve months of the balance sheet date.

## Nature of 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 2010 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.

The Company is working with its bank to secure financing over and above the $500,000 line of credit it currently has. To this end, 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:

| | | |
|---|---|---|
| 2011 | | 667,132 |
| 2012 | | 216,443 |
| | $ | 883,575 |

The above lease commitment amounts are prior to rental expense recoveries of $17,805 in 2011 in relation to sub-lease agreements executed in 2006 and 2007.

The Company entered into a lease agreement in June 2006 and in 2010 has recorded $64,567 (2009 – $119,808) in deferred rent to account for reduced rent benefits received.

Litigation:

In October 2001, a former member of management and director of the Company (the "Claimant") initiated arbitration proceeding asserting that certain amounts were owing to him by the Company. The Company denies that it owes these amounts.

In addition, the Claimant has filed a claim against the Company seeking unspecified damages for wrongful dismissal. The Company considers the allegations in the lawsuit to be without merit and intends to defend the action. The Company has also filed a counterclaim.

The Company's application to dismiss the claim was denied in September 2009 and trial of claims and cross-claims is scheduled to commence in May 2011.

It is not possible to determine the likely outcome of these litigation matters, nor is it possible to determine the nature and amount of consideration, if any, which the Company may have to pay or which it may collect as a result of these proceedings. Provision has been made in the accounts of the Company for these actions.

As announced in the News Release dated September 22, 2010, Photon Control has filed two lawsuits in the United States, the first in the United States District Court, Northern District of California at San Francisco against Azbil North America, Inc. ("Azbil") (formerly Yamatake Sensing Control, Ltd.), a California company with offices in Santa Clara, California, and the second in the Superior Court of the State of California, County of Santa Clara, against Yamatake Corp. ("Yamatake"), a Japanese company with offices in Tokyo, Japan, which is the parent company of Azbil.

Photon Control's claim against Azbil is for damages for breach of contract, including breach of confidentiality, non-disclosure and non-disparagement obligations, misappropriation of trade secrets and interference with Photon Control's rights to its technology, and for an injunction against Azbil to preclude the continued disclosure of confidential information, technology and trade secrets and continued disparagement of Photon Control.

## Related Party Transactions

All transactions with related parties have been translated in the normal course of operations and have been measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. Related party transactions include transactions with Photon Control R&D Ltd. 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.

| Years ended December 31, | 2010 | 2009 |
|---|---|---|
| Balance Sheet: | | |
| Accounts Receivable | $ 810,519 | $ 626,419 |
| Note Receivable | 198,721 | 219,541 |
| Accounts payable | 221,346 | 30,971 |
| Statement of operations: | | |
| Recovery of premises and related expenses | 134,190 | 1,562,859 |
| Engineering, research and development services | 681,955 | 351,131 |
| Royalties | 188,703 | 67,466 |

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 Q1 2011, Photon Control presented its spectrometers and temperature sensors, and promoted the Company's OEM manufacturing capabilities along with seeking new distributorship at Photonics West 2011 in San Francisco, California as well as Pittcon 2011 in Atlanta, Georgia. Due to the success of these events; Photon Control signed 1 additional distributorship agreement for spectrometers for United Kingdom representation.

Also, in Q1 2011, Photon Control successfully completed the ISO 9001:2008 "24 Month Surveillance Audit".

## 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 year ended December 31, 2010. 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 2010, after deferring $219,071 in 2008 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 and so the amount amortized in fiscal 2010 was $37,214 (2009 - $967). The Company has a balance of $152,724, (2009 - $189,938) of deferred development expenses as at December 31, 2010.

### 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.

2,830,000 stock options were granted to certain directors, officers, employees and a consultant of the Company during 2010 compared to nil for 2009.

### 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:

### Credit Risk and Fair Value of Financial Assets and Financial Liabilities

In January 2009, the CICA issued EIC – 173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. The guidance requires that an entity's own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities, including derivative instruments. This guidance is applicable to fiscal periods ending on or after January 20, 2009. The adoption of this section did not have a material impact on the Company's consolidated financial statements.

### Financial Instruments, Disclosure and Presentation

Effective January 1, 2009, the Company has adopted the enhanced disclosure requirements of amended CICA Section 3862, Financial Instruments - Disclosures. Refer to note 12 for fair value measurement disclosures using a fair value hierarchy that reflects the significance of the inputs in making the measurements.

### 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. The effective date of adopting this standard for the Company is January 1, 2009. This standard is not expected to impact the Company's financial statements.

### International Financial Reporting Standards

The CICA's Accounting Standards Board has announced that Canadian publicly accountable enterprises will adopt IFRS as issued by the International Accounting Standards Board effective January 1, 2011. The Company is in the process of developing a plan for the implementation of IFRS and will assess the impact of the differences in accounting standards on the Company's consolidated financial statements.

## OUTLOOK, BUSINESS RISKS AND UNCERTAINTY

### Sales Risks

During the first half of 2009, customers in the Company's semi-conductor market had postponed orders as a consequence of a reduction of demand in their markets. In the final two quarters of 2009, Photon Control saw a recovery of demand from the semi-conductor market, which continued throughout 2010 resulting in sales to this market more than doubled compared with the previous year. Photon Control 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 industry, low cost fibre optic temperature sensors and spectrometers.

### Going Concern Risk

The Company's ability to continue as a going concern is dependant upon its ability to fund working capital and its ability to generate positive cash flows from operations. While 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, there can be no assurance that the Company will be successful in doing so or that the Company would be able to secure funding on acceptable terms when required. 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

Encouraged by the improved economic environment in 2010, Photon Control demonstrated the resilience of the Company's business and ability to generate revenue for the foreseeable future, sustaining profitable financial results for the second consecutive year. In addition, Photon Control continues to be positively influenced by the level of fulfilled and received purchase orders in 2011, which should result in continued revenue growth.

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 United States dollar. As at December 31, 2010, the Company did not utilize any forward exchange contracts to mitigate any of the risks as mentioned above. Photon manages its exposure to foreign currency fluctuation by maintaining Canadian and U.S. dollar bank accounts to offset foreign currency payables and planned expenditures. As at December 31, 2010, the Company was not exposed to significant credit or interest rate risk.

## OUTSTANDING SHARE DATA

As at December 31, 2010 and the date hereof, the Company had 102,909,518 common shares issued and outstanding. There were outstanding stock options to purchase an additional 4,592,500 common shares of the Company as at December 31, 2010 and 4,572,500 common shares of the Company 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.