Consolidated Financial Statements of

KWESST MICRO SYSTEMS INC.

Years ended September 30, 2022, and 2021, and
Nine months ended September 30, 2020

(Expressed in Canadian Dollars)

KWESST MICRO SYSTEMS INC.

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and nine months ended September 30, 2020

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors
KWESST Micro Systems Inc.:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of KWESST Micro Systems Inc. (the Company) as of September 30, 2022 and 2021, the related consolidated statements of net loss and comprehensive loss, shareholders' equity (deficit), and cash flows for each of the years in the two-year period ended September 30, 2022, and the related notes (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of September 30, 2022 and 2021, and its financial performances and its cash flows for each of the years in the two-year period ended September 30, 2022, in conformity with International Financial Reporting Standards as issued by the International Accounting Standard Board.

Going Concern

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2(a) to the consolidated financial statements, the Company has incurred significant losses and negative cash flows from operations since inception that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2(a). The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audit provides a reasonable basis for our opinion.

/s/ KPMG LLP

Chartered Professional Accountants, Licensed Public Accountants

We have served as the Company's auditor since 2021.

Ottawa, ON
January 27, 2023

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Financial Position
At September 30, 2022 and 2021

In Canadian dollars	*Notes*	**September 30, 2022**	September 30, 2021
ASSETS			
Cash		**$ 170,545**	$ 2,688,105
Restricted short-term investment	12	**30,000**	30,000
Trade and other receivables	5	**171,882**	699,251
Inventories	6	**393,538**	90,299
Prepaid expenses and other		**122,166**	548,042
Deferred share offering costs	27(a)	**628,262**	-
Current assets		**1,516,393**	4,055,697
Property and equipment	7	**832,481**	903,649
Right-of-use assets	8	**208,131**	266,214
Deposit	8	**23,604**	21,367
Intangible assets	9	**4,742,854**	3,470,919
Non-current assets		**5,807,070**	4,662,149
Total Assets		**$ 7,323,463**	$ 8,717,846
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Accounts payable and accrued liabilities	10	**$ 4,459,481**	$ 1,127,202
Lease obligations	13	**69,150**	32,288
Accrued royalties liability	4(b)	**150,000**	-
Borrowings	12, 27(b)(c)	**2,199,978**	-
Contract liabilities	14	**47,271**	-
Current liabilities		**6,925,880**	1,159,490
Accrued royalties liability	4(b)	**1,115,207**	1,105,756
Lease obligations	13	**206,471**	275,621
Borrowings	12	**78,796**	53,251
Non-current liabilities		**1,400,474**	1,434,628
Total Liabilities		**8,326,354**	2,594,118
Shareholders' Equity (Deficit)			
Share capital	15(a), 27(a)	**19,496,640**	17,215,068
Warrants	15(b), 27(a)	**1,959,796**	1,848,389
Contributed surplus	15(c)	**3,551,330**	2,458,211
Accumulated other comprehensive loss		**(101,418)**	(8,991)
Accumulated deficit		**(25,909,239)**	(15,388,949)
Total Shareholders' Equity (Deficit)		**(1,002,891)**	**6,123,728**
Total Liabilities and Shareholders' Equity (Deficit)		**$ 7,323,463**	**$ 8,717,846**

See Note 2(a) Going concern and Note 26 Commitments and contingencies.
See accompanying notes to consolidated financial statements.

On behalf of the Board of Directors:

(signed) John McCoach, Director *(signed) David Luxton,* Director

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Net Loss and Comprehensive Loss
Years ended September 30, 2022 and 2021 and nine months ended September 30, 2020

In Canadian dollars	***Notes***	**Year ended September 30, 2022**	Year ended September 30, 2021	Nine months ended September 30, 2020
Revenue	17	**$ 721,519**	$ 1,275,804	$ 861,917
Cost of sales		**(536,735)**	(798,888)	(247,113)
Gross profit		**184,784**	476,916	614,804
Operating expenses				
General and administrative		**4,915,263**	4,057,167	2,723,861
Selling and marketing		**3,296,373**	3,484,159	564,266
Research and development, net	21(a)	**2,064,493**	2,138,138	817,584
Total operating expenses	18	**10,276,129**	9,679,464	4,105,711
Operating loss		**(10,091,345)**	(9,202,548)	(3,490,907)
Other income (expenses)				
Fair value adjustments on derivatives		**-**	-	29,463
Net finance costs	20	**(506,002)**	(107,751)	(61,397)
Foreign exchange gain (loss)		**28,780**	(3,742)	(13,937)
Loss on disposals		**(1,165)**	(1,331)	-
Total other expenses, net		**(478,387)**	(112,824)	(45,871)
Loss before income taxes		**(10,569,732)**	(9,315,372)	(3,536,778)
Income tax recovery				
Deferred tax recovery	21	**49,442**	-	-
Net loss		**$ (10,520,290)**	$ (9,315,372)	$ (3,536,778)
Other comprehensive loss:				
Items that are or may be reclassified subsequently to profit or loss:				
Foreign currency translation differences		**(92,427)**	(8,991)	-
Total comprehensive loss		**$ (10,612,717)**	$ (9,324,363)	$ (3,536,778)
Net loss per share				
Basic and diluted		**$ (14.41)**	$ (14.72)	$ (8.03)
Weighted average number of shares outstanding				
Basic and diluted	16	**730,302**	632,721	440,631

See accompanying notes to consolidated financial statements.

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Changes in Shareholders' Equity (Deficit)
Years ended September 30, 2022 and 2021 and nine months ended September 30, 2020

In Canadian dollars	Notes	Share capital	Contingent shares	Warrants	Contributed surplus	Translation reserve	Deficit	Total Shareholders' Equity (Deficit)
Balance, December 31, 2019		2,284,353		21,050	-	-	(2,536,799)	(231,396)
Shares and warrants issued for cash	15(a),(b)	4,568,013		76,120	-	-	-	4,644,133
Shares for converted debt and interest	15(a)	1,583,881		-	-	-	-	1,583,881
Shares issued for performance incentive	15(a)	731,500		-	-	-	-	731,500
Shares from Foremost's QT	4(c)	628,949		-	41,155	-	-	670,104
Shares and warrants issued on asset acquisition	4(c)	167,280		180,000	-	-	-	347,280
Stock options exercised	15(c)	78,080		-	(17,531)	-	-	60,549
Shares for consulting services	15(a)	32,393		-	-	-	-	32,393
Share-based compensation	15(c)	-		-	283,084	-	-	283,084
Share offering costs	15(a)	(699,886)		-	-	-	-	(699,886)
Net loss		-		-	-	-	(3,536,778)	(3,536,778)
Balance, September 30, 2020		$ 9,374,563	$ -	$ 277,170	$ 306,708	$ -	$ (6,073,577)	$ 3,884,864
Shares for debt settlements	15(a)	63,866	-	-	-	-	-	63,866
Warrants exercised	15(b)	815,307	-	(175,741)	-	-	-	639,566
Shares and warrants issued on asset acquisition	4(b)	1,290,000	-	425,000	-	-	-	1,715,000
Shares for amended license	26	137,000	-	-	-	-	-	137,000
Shares and warrants issued for cash	15(a),(b)	4,721,818	-	1,280,654	-	-	-	6,002,472
Stock options and warrants exercised	15(c)	1,639,695	-	41,306	(531,263)	-	-	1,149,738
Share-based compensation	15(c)	-	-	-	2,462,207	-	-	2,462,207
Restricted share units vested	15(c)	12,498	-	-	(12,498)	-	-	-
Share offering costs	15(a)	(839,679)	-	-	233,057	-	-	(606,622)
Other comprehensive loss		-	-	-	-	(8,991)	-	(8,991)
Net loss		-	-	-	-	-	(9,315,372)	(9,315,372)
Balance, September 30, 2021		$ 17,215,068	$ -	$ 1,848,389	$ 2,458,211	$ (8,991)	$ (15,388,949)	$ 6,123,728
Shares issued to settle debt	15(a)	19,000	-	-	-	-	-	19,000
Shares and warrants issued on acquisition	4(a)	377,503	83,319	132,000	-	-	-	592,822
Shares and warrants issued for cash	15(a),(b)	272,000	-	72,000	-	-	-	344,000
Contingent shares converted to common shares	4(a)	83,319	(83,319)	-	-	-	-	-
Warrants exercised	15(b)	277,098	-	(61,173)	-	-	-	215,925
Warrants expired	15(b)	-	-	(31,420)	31,420	-	-	-
Share-based compensation	15(c)	-	-	-	1,960,072	-	-	1,960,072
Shares for vested RSUs and PSUs	15(c)	874,840	-	-	(874,840)	-	-	-
Vested RSUs and PSUs repurchased for withholding taxes	15(c)	-	-	-	(23,533)	-	-	(23,533)
Shares issued for unsecured loans	12	411,692	-	-	-	-	-	411,692
Share offering costs	15(a)	(33,880)	-	-	-	-	-	(33,880)
Other comprehensive loss		-	-	-	-	(92,427)	-	(92,427)
Net loss		-	-	-	-	-	(10,520,290)	(10,520,290)
Balance, September 30, 2022		**$ 19,496,640**	**$ -**	**$ 1,959,796**	**$ 3,551,330**	**$ (101,418)**	**$ (25,909,239)**	**$ (1,002,891)**

See accompanying notes to consolidated financial statements.

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Cash Flows
Years ended September 30, 2022 and 2021 and nine months ended September 30, 2020

In Canadian dollars	Notes	**Year ended September 30, 2022**	Year ended September 30, 2021	Nine months ended September 30, 2020
OPERATING ACTIVITIES				
Net loss		**$ (10,520,290)**	$ (9,315,372)	$ (3,536,778)
Items not affecting cash:				
Share-based compensation	15(c)	**1,960,072**	2,462,207	283,084
Net finance costs	20	**506,002**	107,751	61,217
Depreciation and amortization	7, 8, 19	**326,491**	140,990	103,397
Deferred tax recovery	21	**(49,442)**	-	-
Loss on disposals		**1,165**	1,331	-
Impairment of intangible assets	9	**-**	55,376	-
Shares for amended license	26	**-**	137,000	-
Shares issued for M&A adivsory and consulting services		**-**	-	763,893
Fair value adjustments on derivative liabilities		**-**	-	(29,463)
Non-cash listing expense		**-**	-	814,703
Changes in non-cash working capital items	23	**3,639,822**	198,484	(245,095)
Interest paid		**(120,416)**	(42,980)	(6,612)
Cash used in operating activities		**(4,256,596)**	(6,255,213)	(1,791,654)
INVESTING ACTIVITIES				
Investments in intangible assets	9	**(1,176,664)**	(83,228)	(163,230)
Acquisition of property and equipment	7	**(187,478)**	(809,964)	(133,927)
Acquisition of technology asset		**-**	-	(134,192)
Cash acquired on acquisition	4(a)	**162,547**	-	-
Recognition of open orders from acquisition	9	**87,802**	-	-
Deposit for advanced royalties	4(b)	**-**	(150,000)	-
Deposit for long-term office lease		**-**	-	(38,212)
Purchase of restricted short-term investment	12	**-**	(30,000)	-
Cash acquired on closing of Foremost		**-**	-	78,589
Cash flows used in investing activities		**(1,113,793)**	(1,073,192)	(390,972)
FINANCING ACTIVITIES				
Proceeds from borrowings	12	**2,543,230**	326,000	40,000
Payments of deferred financing fees	12	**(150,409)**	-	-
Proceeds from the issuance of common shares and warrants	15(a)	**344,000**	6,002,472	4,355,171
Payments of share offering costs	15(a)	**(33,880)**	(606,622)	(164,716)
Proceeds from related party advances	11	**60,000**	-	-
Repayments to related party advances	11	**(60,000)**	(218,276)	(80,000)
Proceeds from exercise of warrants	15(b)	**215,925**	680,872	-
Proceeds of convertible notes and converted to equity		**-**	-	1,081,504
Repayments of lease obligations	13	**(42,504)**	(44,128)	(58,188)
Repurchase of vested RSUs and PSUs for withholding taxes		**(23,533)**	-	-
Repayment of borrowings	12	**-**	(306,000)	-
Proceeds from exercise of stock options	15(c)	**-**	1,108,432	61,000
Cash flows provided by financing activities		**2,852,829**	6,942,750	5,234,771
Net change in cash during the year		**(2,517,560)**	(385,655)	3,052,145
Cash, beginning of year		**2,688,105**	3,073,760	21,615
Cash, end of year		**$ 170,545**	$ 2,688,105	$ 3,073,760

See Note 23 Supplemental cash flow information.
See accompanying notes to consolidated financial statements.

1. Corporate information

a) Corporate information

KWESST Micro Systems Inc. (the "Company", "KWESST", "we", "our", and "us") was incorporated on November 28, 2017, under the laws of the Province of British Columbia. Our registered office is located at 550 Burrard Street, Suite 2900, Vancouver, British Columbia, Canada and our corporate office is located at Unit 1, 155 Terrence Matthews Crescent, Ottawa, Ontario, Canada. We have representative offices in the following foreign locations: Washington DC (United States), London (United Kingdom), and Abu Dhabi (United Arab Emirates).

We develop and commercialize next-generation technology solutions that deliver a tactical advantage for military, public safety agencies and personal defense markets. Our core mission is to protect and save lives.

KWESST's common stock is listed on the TSX-Venture Exchange ("TSX-V'') under the stock symbol of KWE and on the Frankfurt Stock Exchange under the stock symbol of 62U. As a result of the U.S. IPO (see Note 28 (a), *Subsequent Events – U.S. IPO and Canadian Offering*), KWESST's common stock and warrants issued under the Form F-1 Registration Statement are also listed on the Nasdaq Capital Market ("Nasdaq") under the stock symbol of KWE and KWESW, respectively, as of December 7, 2022.

b) Reverse Stock Split

In August 2022, we submitted a Form F-1 Registration Statement to the U.S. Securities and Exchange Commission and applied to have its common shares listed on the Nasdaq Capital Market ("Nasdaq"). In connection with KWESST's listing application on Nasdaq, KWESST effected a one for seventy (1-for-70) reverse stock split of its common stock on October 28, 2022 (the "Reverse Split"). Accordingly, all shareholders of record at the opening of business on October 28, 2022, received one issued and outstanding common share of KWESST in exchange for seventy outstanding common shares of KWESST. No fractional shares were issued in connection with the Reverse Split. All fractional shares created by the Reverse Split were rounded to the nearest whole number of common shares, with any fractional interest representing 0.5 or more common shares entitling holders thereof to receive one whole common share.

Effective on the date of the Reverse Split, the exercise price and number of common shares issuable upon the exercise of outstanding stock options were proportionately adjusted to reflect the Reverse Split. The restricted share units ("RSUs") and performance stock units ("PSUs") have also been adjusted for the Reverse Split. While the number of warrants has not changed as a result of the Reverse Split; the conversion rate for each warrant was adjusted from one common share to 0.01428571 common share. All information respecting outstanding common shares and other securities of KWESST, including net loss per share, in the current and comparative periods presented herein give effect to the Reverse Split.

2. Basis of preparation

(a) Going concern

These consolidated financial statements have been prepared assuming we will continue as a going concern. The going concern basis of presentation assumes we will continue in operation for the foreseeable future and can realize our assets and discharge our liabilities and commitments in the normal course of business.

As an early-stage company, we not yet reached commercial production for most of our products and have incurred significant losses and negative operating cash flows from inception that have primarily been funded from financing activities. We have incurred a $10.5 million net loss and negative operating cash flows of approximately $4.3 million for the year ended September 30, 2022 (2021 - $9.3 million net loss and negative operating cash flows of $6.3 million). At September 30, 2022, we had $5.4 million in negative working capital (2021 – positive working capital of $2.9 million).

Our ability to continue as a going concern and realize our assets and discharge our liabilities in the normal course of business is dependent upon closing timely additional sales orders, timely commercial launch of new products, and the ability to raise additional debt or equity financing, when required. There are various risks and uncertainties affecting our future financial position and our performance including, but not limited to:

- The market acceptance and rate of commercialization of our product offerings;
- Ability to successfully execute our business plan;
- Ability to raise additional capital at acceptable terms;
- General local and global economic conditions, including the ongoing COVID-19 pandemic and the global disruption from Russia's invasion of Ukraine.

Our strategy to mitigate these material risks and uncertainties is to execute timely a business plan aimed at continued focus on revenue growth, product development and innovation, improving overall gross profit, managing operating expenses and working capital requirements, and securing additional capital, as needed.

Failure to implement our business plan could have a material adverse effect on our financial condition and/or financial performance. There is no assurance that we will be able to raise additional capital as they are required in the future. Accordingly, there are material risks and uncertainties that may cast significant doubt about KWESST's ability to continue as a going concern.

Subsequent to September 30, 2022, we closed our U.S. IPO and Canadian public offering on December 9, 2022, resulting in total gross proceeds of US$14.1 million or CAD$19.2 million (see Note 27(a)).

These consolidated financial statements do not include any adjustments to the carrying amounts and classification of assets, liabilities and reported expenses that may otherwise be required if the going concern basis was not appropriate.

(b) Statement of compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") and interpretations of the IFRS Interpretations Committee ("IFRIC").

The consolidated financial statements were authorized for issue by the Board of Directors effective on January 27, 2023.

(c) Principles of consolidation

These consolidated financial statements incorporate the financial statements of KWESST and the entities it controls.

Control is achieved where we have the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities, are exposed to, or have rights to, variable returns from our involvement with the entity and have the ability to affect those returns through its power over the entity. Subsidiaries are fully consolidated from the date on which control is transferred to us until the date on which control ceases. Profit or loss of subsidiaries acquired during the year are recognized from the date of acquisition or effective date of disposal as applicable. All intercompany transactions and balances have been eliminated.

At September 30, 2022, we have the following wholly-owned subsidiaries:

	Location	Equity %
KWESST Inc.	Ottawa, Canada	100%
2720178 Ontario Inc.	Bowmanville, Canada	100%
Police Ordnance Company Inc.	Bowmanville, Canada	100%
KWESST U.S. Holdings Inc.	Delaware, Canada	100%
KWESST Defense Systems U.S. Inc.	Virginia, United States	100%
KWESST Public Safety Systems U.S. Inc.	Virginia, United States	100%
KWESST Public Safety Systems Canada Inc.	Ottawa, Canada	100%

(d) Functional and presentation currency

The consolidated financial statements are presented in Canadian dollars ("CAD"), which is the functional currency of KWESST and its subsidiaries unless otherwise stated.

(e) Measurement basis

The consolidated financial statements have been prepared on the historical cost basis. Historical cost is generally based on the fair value of the consideration given in exchange for assets.

(f) Use of judgments and estimates

The preparation of the consolidated financial statements in accordance with IFRS requires management to make judgments, estimates, and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income, expenses, and disclosure of contingent liabilities. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to estimates are recognized prospectively.

Judgments

Information about judgments made in applying accounting policies that have the most significant effects on the amounts recognized in these consolidated financial statements is included in the following notes:

- Note 4(a) - *acquisition of Police Ordnance:* whether the consideration transferred and purchase price allocation assumptions used as inputs in determining the fair value of net assets acquired is reasonable.

- Note 4(b) - *acquisition of PARA OPS™ System*: whether the estimated discount rate used to discount the minimum royalty payments is reasonable, and the reasonability of the volatility assumption used in the Black Scholes option model to estimate the fair value of the warrants issued to DEFSEC.

- Note 10 – *unsecured loans:* whether the estimated market discount rate used to estimate the fair value of the unsecured loans is reasonable.

- Note 15(c) - *share-based compensation*: whether the determination of KWESST's stock volatility, forfeiture rate, and expected life are reasonable in light of its limited operating history, all significant inputs in the valuation model to fair value options granted; and

- Note 15(c) - *broker compensation options*: whether the Monte Carlo valuation model and number of simulations, coupled with the volatility assumption, are reasonable to estimate the fair value of these options.

Estimates

Information about assumptions and estimation uncertainties at September 30, 2022, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next financial year is included in the following notes:

- Note 9 - *impairment test of intangible assets*: key assumptions underlying recoverable amounts.

COVID-19 and Economic Uncertainties

While COVID-19 has not had a material impact to our business to date, the following is a summary of what we believe may impact our future business given the persistency of COVID-19: disruptions to business operations resulting from quarantines of employees, customers, manufacturers and other third-party service providers in areas affected by the outbreak; disruptions to business operations resulting from travel restrictions, including travel to industry tradeshows; and uncertainty around the duration of the virus' impact.

Despite the global vaccination efforts underway, the extent to which COVID-19 could impact our operations, financial condition, results of operations, and cash flows is highly uncertain and cannot be predicted. Negative financial results, uncertainties in the market, and a tightening of credit markets, caused by COVID-19, or a recession, could have a material adverse effect on our liquidity and ability to obtain financing in the future.

3. Significant accounting policies

(a) Revenue recognition

Revenue is recognized upon transfer of control of products or services to customers at an amount that reflects the transaction price we expect to receive in exchange for the products or services. Our contracts with customers may include the delivery of multiple products and services, which are generally capable of being distinct and accounted for as separate performance obligations. The accounting for a contract or contracts with a customer that contain multiple performance obligations requires us to allocate the contract or contracts transaction price to the identified distinct performance obligations based on the stand-alone selling price of each performance obligation.

Revenue from contracts with customers is recognized, for each performance obligation, either over a period of time or at a point in time, depending on which method reflects the transfer of control of the goods or services underlying the particular obligation to the customer.

For performance obligations satisfied over time, we recognize revenue over time using an input method, based on costs incurred to date relative to total estimated costs at completion, to measure progress toward satisfying such performance obligation (for non-recurring engineering services, the input method is based on hours). Under this method, costs that do not contribute to the performance of KWESST in transferring control of goods or services to the customer are excluded from the measurement of progress toward satisfying the performance obligation. In certain other situations, we might recognize revenue at a point in time, when the criteria to recognize revenue over time are not met. In any event, when the total anticipated costs exceed the total anticipated revenues on a contract, such loss is recognized in its entirety in the period it becomes known.

We may enter into contractual arrangements with a customer to deliver services on one project with respect to more than one performance obligation, such as non-recurring engineering, procurement, and training. When entering into such arrangements, we allocate the transaction price by reference to the stand-alone selling price of each performance obligation. Accordingly, when such arrangements exist on the same project, the value of each performance obligation is based on its stand-alone price and recognized according to the respective revenue recognition methods described above. For example, for non-recurring engineering services rendered over a contract period the revenue is recognized using the percentage of completion method; whereas for training services the revenue is recognized after the training is delivered (i.e. point in time).

We account for a contract modification, which consists of a change in the scope or price (or both) of a contract, as a separate contract when the remaining goods or services to be delivered after the modification are distinct from those delivered prior to the modification and the price of the contract increases by an amount of consideration to a price which reflects KWESST's stand-alone selling price of the additional promised goods or services. When the contract modification is not accounted for as a separate contract, we recognize an adjustment to revenue on a cumulative catch-up basis at the date of contract modification.

The timing of revenue recognition often differs from performance payment schedules, resulting in revenue that has been earned but not billed. These amounts are included in unbilled receivables. Amounts billed in accordance with customer contracts, but not yet earned, are recorded and presented as part of contract liabilities.

When a contract includes a significant financing component, the value of such component is excluded from the transaction price and is recognized separately as finance income or expense, as applicable.

(b) Business combinations

We account for business combinations using the acquisition method. Goodwill arising on acquisitions is measured as the fair value of the consideration transferred less the net recognized amount of the estimated fair value of identifiable assets acquired and liabilities assumed, all measured as of the acquisition date. Transaction costs that we incur in connection with a business combination are expensed as incurred. We use our best estimates and assumptions to reasonably value assets acquired and liabilities assumed at the acquisition date as well as contingent consideration, where applicable, and these estimates are inherently uncertain and subject to refinement. As a result, during the measurement period, which may be up to one year from the acquisition date, we may record adjustments to the assets acquired and liabilities assumed with a corresponding offset to goodwill. Upon conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded in profit or loss.

Where the total purchase consideration is less than the fair value of identifiable net assets, we recognize a gain on acquisition.

Acquisitions that do not meet the definition of a business are accounted for as asset acquisitions in accordance with the relevant IFRS standards and applicable to the type of asset acquired.

(c) Financial instruments

We recognize a financial asset or a financial liability when it becomes a party to the contractual provisions of the instrument.

Trade and other receivables without a significant financing component are initially measured at the transaction price. All other financial assets and financial liabilities are initially recognized at fair value. Transaction costs that are directly attributable to the acquisition or issue of financial assets and financial liabilities (other than financial assets and financial liabilities at fair value through profit or loss ("FVTPL")) are added to or deducted from the fair value of the financial assets or financial liabilities, as appropriate, on initial recognition. Transaction costs directly attributable to the acquisition of financial assets or financial liabilities at fair value through profit or loss are recognized immediately in profit or loss.

Financial assets

All financial assets are recognized and de-recognized on trade date.

Financial assets are recognized at fair value and subsequently classified and measured at:

a) Amortized cost;
b) Fair value through other comprehensive income ("FVOCI"); or
c) Fair value though profit or loss ("FVTPL").

We determine the classification of our financial assets on the basis of both the business model for managing the financial assets and the contractual cash flows characteristics of the financial asset. Financial assets are not reclassified subsequent to their initial recognition unless we change our business model for managing financial assets.

A financial asset is measured at amortized cost if it is held within a business model whose objective is to hold assets to collect contractual cash flows, and its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest of the principal amount outstanding. Financial assets classified at amortized cost are measured using the effective interest method. At September 30, 2022, we classified the following as amortized cost:

- Cash
- Restricted short-term investment
- Trade and other receivables
- Lease deposit (non-current other asset)

All financial assets not classified and measured at amortized cost or FVOCI are measured at FVTPL. At September 30, 2022, we did not have financial assets classified as FVOCI or FVTPL.

Expected credit losses

We measure a loss allowance based on the lifetime expected credit losses. Lifetime expected credit losses are estimated based on factors such as our past experience of collecting payments, the number of delayed payments in the portfolio past the average credit period, observable changes in national or local economic conditions that correlate with default on receivables, financial difficulty of the borrower, and it becoming probable that the borrower will enter bankruptcy or financial re-organization.

Financial assets are written off when there is no reasonable expectation of recovery.

<u>Financial liabilities</u>

Financial liabilities are recognized at fair value and subsequently classified and measured at amortized cost or fair value though profit or loss ("FVTPL").

We determine the classification of our financial liabilities at initial recognition. We have classified the following as amortized costs:

- Accounts payable and accrued liabilities
- Corporate tax payable
- Borrowings
- Lease obligations
- Accrued royalties liability

Financial liabilities at amortized cost are measured using the effective interest rate method.

De-recognition of financial liabilities

KWESST de-recognizes financial liabilities when its obligations are discharged, cancelled or they expire.

(d) Cash and cash equivalents

Cash and cash equivalents include cash investments in interest-bearing accounts and term deposits which can readily be redeemed for cash without penalty or are issued for terms of three months or less from dated of acquisition.

(e) Inventories

KWESST's inventories may consist of raw materials, work-in-progress ("WIP"), and finished goods. Inventories are measured at the lower of cost and net realizable value, with cost being determined using the weighted average cost method. The cost of WIP and finished goods includes the cost of raw materials, direct labour, and overhead. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses. At each reporting period, management estimates the provision for obsolete and slow-moving inventory which may be reversed in subsequent periods, should the value subsequently be recovered.

(f) Property and equipment

Property and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. Cost comprises the fair value of consideration given to acquire or construct an asset and includes the direct charges associated with bringing the asset to the location and condition necessary for putting it into use along with the future cost of dismantling and removing the asset. These assets are depreciated over their estimated useful lives using the straight-line method as this most closely reflects the expected pattern of consumption of the future economic benefits. Depreciation methods, useful lives and residual values are reviewed at each financial year end and adjusted prospectively, if appropriate.

The following table provides a summary of estimated useful lives for our property and equipment:

	Rate
Computer equipment	3 years
Computer software	3 years
Office furniture and equipment	5 years
Low-rate initial production equipment	5 years
R&D equipment	5 years
Sales demo equipment	2 years
Leasehold improvements	Shorter of useful life or remaining term of lease

At the end of each reporting period, we review the carrying amounts of its property and equipment to determine whether there is any indication of impairment. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). The recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For the purpose of impairment testing, assets that cannot be tested individually are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash flows of other assets or groups of assets (the "cash-generating unit, or CGU"). If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. An impairment loss is recognized immediately in profit or loss.

Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

(g) Leases

At inception of a contract, we assess whether a contract is, or contains, a lease based on whether the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

We recognize a right-of-use asset and a lease liability at the lease commencement date. The lease obligation is measured at the present value of the lease payments that are not paid at the commencement date of the lease, discounted using its incremental borrowing rate at the inception of the lease (it was 10% for the current outstanding lease agreement). The right-of-use asset is initially measured based on the initial amount of the lease liability adjusted for any lease payments made at or before the commencement date, plus any initial direct costs incurred and an estimate of costs to dismantle and remove the underlying asset or to restore the underlying asset or the site on which it is located, less any lease incentives received. The assets are depreciated to the earlier of the end of the useful life of the right-of-use asset or the lease term using the straight-line method as this most closely reflects the expected pattern of consumption of the future economic benefits. The lease term includes periods covered by an option to extend if we are reasonably certain to exercise that option. In addition, the right-of-use asset is periodically reduced by impairment losses, if any, and adjusted for certain remeasurements of the lease liability.

The lease liability is initially measured at the present value of the lease payments that are not paid at the commencement date, discounted using the interest rate implicit in the lease or, if that rate cannot be readily determined, our incremental borrowing rate. Variable lease payments that do not depend on an index or rate are not included in the measurement of the lease liability.

The lease liability is measured at amortized cost using the effective interest method. It is remeasured when there is a change in future lease payments arising from a change in an index or rate, if there is a change in our estimate of the amount expected to be payable under a residual value guarantee, or if we change our assessment of whether it will exercise a purchase, extension, or termination option. When the lease liability is remeasured in this way, a corresponding adjustment is made to the carrying value of the right-of-use asset or, is recorded in profit or loss if the carrying amount of the right-of-use asset has been reduced to zero.

We have elected to apply the practical expedient not to recognize right-of-use assets and lease liabilities for short-term leases that have a lease term of 12 months or less and leases of low-value assets. The lease payments associated with these leases are recognized as an expense on a straight-line basis over the lease term.

(h) Intangible assets

(i) Research and development ("R&D") costs

Expenditure on research activities, undertaken with the prospect of gaining new scientific or technical knowledge and understanding, is recognized in profit or loss when incurred.

Development expenditure is capitalized only if development costs can be measured reliably, the product or process is technically and commercially feasible, future economic benefits are probable, and we have the intention and sufficient resources to complete the development and to use or sell the asset. The expenditure capitalized in respect of development activities includes the cost of materials, direct labor and overhead costs that are directly attributable to preparing the asset for its intended use, and capitalized borrowing costs. Other development expenditures are recognized in profit or loss when incurred.

(ii) Subsequent expenditure

Subsequent expenditure is capitalized only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditures, including expenditure on internally generated goodwill and brands, is recognized in profit or loss as incurred.

(iii) Acquired intangible assets

Acquired intangible assets consist of open customer orders, tradenames, customer relationships, patents, and technology assets acquired either through an asset purchase or a business combination transaction. These intangible assets are recorded at their fair value at the acquisition date.

After initial recognition, except for open customer orders, intangible assets are measured at cost less any accumulated amortization and impairment losses. For open customer orders, we reduce the amount when we have delivered under the customer contract, with an offset to accounts receivable (i.e. there is no revenue recognized for acquired open customer orders). Intangible assets with finite useful lives are amortized on a straight-line basis over their estimated useful lives. Amortization begins when the related acquired technology is commercialized. We anticipate the estimated useful life for the current technology assets to be five years once commercialized.

(iv) Amortization

Amortization is a systematic allocation of the amortizable amount of an intangible asset of its useful life. The amortizable amount is the cost of the asset less its estimated residual value. We recognize in profit or loss on a sales-based rate over the estimated useful lives of the intangible assets from the date they are available for use, since this method most closely reflects the expected pattern of consumption of the future economic benefits embodied in each asset. Where a sales-based rate could not be determined, the straight-line approach is used.

Internally generated intangible assets are not systematically amortized as long as they are not available for use i.e. they are not yet in working condition for their intended use. Accordingly, intangible assets such as development costs are tested for impairment at least once a year, until such date as they are available for use.

(v) Impairment

All intangible assets are periodically reviewed for impairment. The estimated present value of future cash flows associated with the intangible asset is determined and an impairment loss is recognized for the difference between this amount and the carrying amount as follows: the carrying amount of the asset is reduced to estimated present value of the future cash flows associated with the asset, discounted at the financial asset's original effective interest rate, and the resulting loss is directly recognized in profit or loss for the period.

(i) Provisions

A provision is recognized if, as a result of a past event, we have a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risk specific to the liability. The accretion of the discount is recognized as a finance cost.

(j) Income taxes

Income tax expense comprises current income tax expense and deferred income tax expense. Current and deferred income taxes are recognized as an expense and included in profit or loss for the period, except to the extent that the tax arises from a transaction which is recognized in other comprehensive income or directly in shareholder's deficiency.

Current income tax

Current tax expense is the amount of income taxes payable (recoverable) in respect of the taxable income (tax loss) for a period. Current liabilities (assets) for the current and prior periods are measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates that have been enacted or substantively enacted by the end of the reporting period.

Deferred income tax

Deferred tax assets and liabilities are recognized for the temporary differences between transactions and carrying amounts of assets and liabilities that have been included in the consolidated financial statements and the amounts used for taxation purposes. Deferred income taxes are provided for using the liability method. Under the liability method, deferred income taxes are recognized for all significant temporary differences between the tax and financial statement bases of assets and liabilities and for certain carry-forward items. Deferred income tax assets are recognized only to the extent that it is probable that the deferred income tax assets will be realized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent it is no longer probable that the related tax benefit will be realized.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the reporting period. Deferred income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of the enactment or substantive enactment. Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and we intend to settle our current tax assets and liabilities on a net basis.

Investment tax credits

Investment tax credits relating to scientific research and experimental development expenditures are recorded in the fiscal period the qualifying expenditures are incurred based on management's interpretation of applicable legislation in the Income Tax Act of Canada. Credits are recorded provided there is reasonable assurance that the tax credit will be realized. Credits claimed are subject to review by the Canada Revenue Agency.

Credits claimed in connection with R&D activities are accounted for using the cost reduction method. Under this method, assistance and credits relating to the acquisition of equipment is deducted from the cost of the related assets, and those relating to current expenditures, which are primarily salaries and related benefits, are included in the determination of profit or loss as a reduction of the R&D expenses.

(k) Related party transactions

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence. Related parties may be individuals or corporate entities. A transaction is considered to be a related party transaction when there is a transfer of resources or obligations between related parties. Related party transactions are in the normal course of business and have commercial substance.

(l) Share-based compensation

We have a Long-Term Incentive Plan ("LTIP") in which we may grant stock options, restricted share units ("RSUs"), performance stock units ("PSUs"), deferred stock units ("DSUs"), and stock appreciation rights ("SARs") to directors, employees and consultants. We measure share-based compensation at fair value for all share-based awards granted under the LTIP.

Equity-settled service award

The grant date fair value of equity-settled share-based awards is recognized as an expense on a straight-line basis over the requisite service period, with a corresponding increase in equity, over the vesting period of the awards. For stock options, the grant date fair value is determined using the Black-Scholes option model. For share units, the grant date fair value is based on KWESST's closing stock price. Each tranche of an award is considered a separate award with its own vesting period and grand date fair value. The amount recognized as an expense is adjusted for estimated forfeitures.

Equity-settled performance award

The accounting for equity-settled performance award is the same as above, except compensation expense is subject to periodic adjustment based on the achievement of establishment performance criteria.

Modified award

Where the terms of an equity-settled transaction award are modified, the minimum expense recognized is the expense as if the terms had not been modified and if the original terms of the award are met. An additional expense is recognized for any modification that increases the total fair value of the share-based payment transaction or is otherwise beneficial to the employees as measured at the date of acquisition.

(m) Foreign currency

Foreign currency transactions

The financial statements of KWESST and its Canadian wholly-owned subsidiaries are measured using CAD as the functional currency. Transactions in currencies other than in CAD are translated at the exchange rates prevailing at the dates of the transactions. At the end of each reporting period, monetary items denominated in foreign currencies are translated to the functional currency at the rates prevailing at that date. Exchange differences on monetary items are recognized in profit or loss in the period in which they arise. Non-monetary items carried at fair value that are denominated in foreign currencies are translated to the functional currency at the rates prevailing at the date when the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the rates at the date of the transaction and are not subsequently retranslated.

Foreign operations

The financial statements of KWESST's U.S. owned subsidiaries are measured using the United States dollar ("USD") as its functional currency. Assets and liabilities have been translated into USD using exchange rates prevailing at the end of each reporting period. Income and expense items are translated at the average exchange rates for the period, unless exchange rates fluctuate significantly during that period, in which cases the exchange rates at the dates of the transactions are used. Exchange differences arising, if any, are recognized in other comprehensive income and accumulated in shareholders' equity.

(n) Earnings (loss) per share

Basic earnings (loss) per share is computed using net earnings (loss) over the weighted average number of common shares outstanding during the period. We use the treasury stock method to compute the dilutive effect of options, warrants, and similar instruments. Under this method, the dilutive effect on earnings per share is calculated presuming the exercise of outstanding options, warrants, and similar instruments. It assumes that the proceeds of such exercise would be used to repurchase common shares at the average market price during the period.

However, the calculation of diluted loss per share excludes the effects of various conversions and exercises of convertible debt, options and warrants that would be anti-dilutive.

(Expressed in Canadian dollars, except share amounts)

4. Acquisitions

a) Police Ordnance

On December 15, 2021, we acquired 2720178 Ontario Inc., an Ontario (Canada) corporation, which owns all of the issued and outstanding shares of Police Ordnance Company Inc., an Ontario (Canada) corporation (together, "Police Ordnance"), herein referred as the "Police Ordnance Acquisition". Located in Bowmanville, Ontario, with ancillary operations in Florida, Police Ordnance owns all intellectual properties to the ARWEN™ product line of launchers, and a proprietary line of 37 mm cartridges designed for riot control and tactical teams. Police Ordnance has law enforcement customers across Canada, the United States, and abroad. The Police Ordnance Acquisition provides us with a strategic opportunity to leverage its law enforcement customer base to accelerate growth within its specialty ordnance business.

We accounted for the acquisition of Police Ordinance pursuant to IFRS 3, *Business Combinations*.

Consideration Transferred:

The purchase consideration comprised of the following:

	Number		Fair Value
Common shares	3,965	$	377,503
Warrants	200,000	$	132,000
Contingent shares	875	$	83,319
Total fair value purchase consideration		**$**	**592,822**

The warrants are exercisable at $1.72 each and will expire on December 15, 2024. As a result of the Reverse Split (see Note 1(b)), each warrant converts into 0.01428571 common share or 70 warrants to receive one common share of KWESST.

We issued the 875 contingent common shares to the sellers in April 2022 following the fulfillment of the financial milestone as defined in the share purchase agreement.

We have estimated the fair value as follows:

- *Common shares*: based on KWESST's closing stock price on December 15, 2021.
- *Warrants*: based on using the Black Scholes option model with the following key inputs: a) exercise price of $1.72, 1/70 of the underlying stock price of $1.36, risk free rate of 1.04%, expected life of three years, and expected volatility of 84.7%.
- *Contingent shares*: based on KWESST's closing stock price on December 15, 2021, and high probability of achieving the financial milestone as defined in the share purchase agreement.

The net cash inflow as at the closing of the acquisition was as follows:

Cash assumed on acquisition	$	162,547
less: consideration paid in cash		-
Net cash inflow on acquisition	**$**	**162,547**

(Expressed in Canadian dollars, except share amounts)

Net Assets Acquired:

The purchase consideration was allocated to Police Ordnance's net assets as follows:

Total purchase consideration at fair value	**$**	**592,822**
Police Ordnance's net assets:		
Cash		162,547
Trade and other receivables		104,432
Inventories		352,685
Intangible assets:		
Purchase orders		100,000
Customer relationships		50,000
ARWEN™ tradename		44,000
Accounts payable and accrued liabilities		82,963
Corporate tax liability		32,338
Contract liabilities		29,861
Borrowings		26,238
Deferred tax liabilities		49,442
Net assets at fair value	**$**	**592,822**

As a result of the above purchase price allocation, we have recorded no goodwill for the Police Ordnance Acquisition.

Impact on KWESST's Results of Operations:

The results of operations of Police Ordnance are included in these consolidate statements of net loss and comprehensive loss from December 16, 2021. For the year ended September 30, 2022, Police Ordnance contributed revenue of $355,296 and net loss of $198,353 to our consolidated results.

If the acquisition had occurred on October 1, 2021, management estimates that Police Ordnance would have contributed approximately $846,600 of revenue and approximately $31,000 of net profit to our operating results for the year ended September 30, 2022, respectively. In determining these amounts, we have assumed that the fair value adjustments that arose on the date of the acquisition would have been the same if the acquisition had occurred on October 1, 2021.

We incurred immaterial acquisition-related costs.

b) LEC System

On April 29, 2021, we acquired the Low Energy Cartridge technology from DEFSEC, a proprietary non-lethal cartridge-based firing system (subsequently branded as PARA OPS™ system). This technology acquisition includes all intellectual property rights for the PARA OPS™ system. With this acquisition, we will target the following four market segments that currently use a variety of dated "non-lethal" or "less-lethal" systems:

(i) public order (riots and control of dangerous subjects);
(ii) military and law enforcement training (realistic force-on-force training);
(iii) personal defence (home, car, boat, RV, camping, hiking); and
(iv) high-action gaming.

As DEFSEC is a private company owned by our Executive Chairman, this asset acquisition is a related party transaction. We relied on exemptions from the formal valuation and minority shareholder approval requirements available under Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions.*

(Expressed in Canadian dollars, except share amounts)

However, we obtained approval from over 51% disinterested shareholders as well as from the TSX-V prior to closing the acquisition.

We accounted for the acquisition of the PARA OPS™ pursuant to IFRS 2, *Share-Based Payment.*

The purchase consideration consisted of:

- 14,286 common shares of KWESST; and
- 500,000 warrants to purchase our common shares at $0.70 each per 1/70 of a common share (70 warrants for one common share); 25% vesting on the first anniversary of the closing of the acquisition and 25% per annum thereafter. These warrants will expire on April 29, 2026.

Additionally, we will pay 7% royalty on annual sales of the PARA OPS™ system to DEFSEC, net of taxes and duties, up to a maximum of $10 million, subject to minimum annual royalty payments starting in 2022. At closing of the acquisition, we made an upfront payment of $150,000 as an advance on future royalty payments.

The minimum annual royalty payments are as follows:

Date	Amount
April 29 2023	$ 150,000
April 29 2024	$ 150,000
April 29 2025	$ 200,000
April 29 2026	$ 200,000
April 29 2027	$ 250,000
April 29 2028	$ 250,000
April 29 2029	$ 300,000
April 29 2030	$ 300,000
April 29 2031	$ 350,000
April 29 2032	$ 350,000
Total	$ 2,500,000

The royalty payment obligation of the Purchase Agreement ("Agreement") will expire in 20 years unless terminated earlier under the terms set out in the Agreement. At our sole discretion, we may terminate this Agreement for convenience, including if market conditions for sales of the PARA OPS™ system become unfavorable subject 60 day's prior written notice. Upon termination, we will be fully released and discharged by DEFSEC including the outstanding future royalties and any unvested warrants shall be immediately cancelled. In return, we will return all intellectual property rights relating to the PARA OPS™ system to DEFSEC.

The purchase price was determined as follows:

	Number		Fair Value
Common shares	14,286	$	1,290,000
Warrants	500,000	$	425,000
Minimum royalty payments		$	1,191,219
Total		**$**	**2,906,219**
Identifiable intangible assets			
Technology asset		**$**	**2,906,219**

(Expressed in Canadian dollars, except share amounts)

We estimated the fair value as follows:

- *Common shares*: based on KWESST's closing stock price on April 29, 2021.
- *Warrants*: based on using the Black Scholes option model with the following key inputs: a) exercise price of $0.70, 1/70 of the underlying stock price of $1.29, risk free rate of 0.48%, expected life of three years, and expected volatility of 80%.
- *Minimum royalty payments*: based on the income approach, specifically discounted cash flows, using a discount rate of 13.7% per annum.

During the year ended September 30, 2022, we recorded $159,451 of accretion cost relating to the discounted minimum royalty payments, which is included in net finance costs in the consolidated statements of net loss and comprehensive loss (2021 - $64,537). As at September 30, 2022, $1,265,207 of accrued royalties liability was outstanding (2021 - $1,105,756).

c) Reverse acquisition

On September 17, 2020, Foremost Ventures Corp. ("Foremost") completed the Qualifying Transaction ("QT") with KWESST Inc. pursuant to the policies of the TSX-V. Prior to the completion of the QT, Foremost effected a consolidation of its outstanding common shares on the basis of one post-consolidation common share for every 326.9 pre-consolidation common shares. The QT was done by way of a three-cornered amalgamation (the "Amalgamation") pursuant to which, among other things:

(i) KWESST Inc. amalgamated with a wholly-owned subsidiary of Foremost, incorporated for the purposes of the Amalgamation, pursuant to the provisions of the Business Corporations Act (Ontario),
(ii) Foremost changed its name to KWESST Micro Systems Inc., and
(iii) all of the outstanding common shares of KWESST Inc. (the "KWESST Shares") were cancelled and, in consideration the holders thereof received post-consolidation common shares of KWESST Micro Systems Inc. on the basis of one KWESST Micro System Inc. share for each KWESST Share.

Immediately following the QT, there were 589,517 shares of KWESST outstanding, of which 576,681 were held by the former shareholders of KWESST Inc. (representing approximately 97.8% of the outstanding shares of the Company) and 12,836 were held by the shareholders of Foremost prior to the QT. Accordingly, this transaction was accounted for as a reverse acquisition where KWESST Inc. was deemed to be the acquirer for accounting purposes.

The reverse acquisition of Foremost was accounted for under IFRS 2, *Share-based Payment*. Accordingly, the fair value of the purchase consideration was accounted for at the fair value of the equity instruments granted by the shareholders of KWESST Inc. to the shareholders and option holders of Foremost.

The following represents management's estimate of the fair value of the net assets acquired and total consideration transferred at September 17, 2020, the closing date of the QT.

Number of common shares issued to Foremost shareholders		12,836
KWESST's stock price at closing of reverse acquisition (1)	$	49.00
Common shares	$	628,949
Options		41,155
Total consideration transferred	$	670,104

(1) At closing, the subscription receipts issued by KWESST Inc. on July 9, 2020 pursuant to a brokered private placement (the "KWESST Subscription Receipts"), were automatically converted, into shares of KWESST. The private placement which was completed through PI Financial Corp. as agent, consisted of 62,994 KWESST Subscription Receipts issued at $49.00 per KWESST Subscription Receipt for gross proceeds of about $3.1 million before share issuance costs. See Note 16(a).

(Expressed in Canadian dollars, except share amounts)

The total fair value consideration was allocated to Foremost's net assets as follows:

Total fair value consideration	**$**	**670,104**
Foremost's net assets (liabilities):		
Cash	$	78,589
Other receivables		1,900
Accounts payable and accrued liabilities		(225,088)
Net assets (liabilities) at fair value		(144,599)
Residual balance allocated to listing expense (included in M&A costs)		814,703
Total	**$**	**670,104**

The results of operations of Foremost are included in these consolidated statements of comprehensive loss from September 17, 2020.

The listing expense of $814,703 is a non-cash item – see consolidated statements of cash flows.

In addition, 14,286 common shares with fair value of $700,000 were issued to two M&A / capital market advisors for successfully assisting KWESST to complete the QT.

5. Trade and other receivables

The following table presents a breakdown of our trade and other receivables:

		September 30, 2022		September 30, 2021
Trade receivables	**$**	**114,877**	$	-
Unbilled revenue		**8,881**		308,728
Sales tax recoverable		**48,124**		183,761
Investment tax credits refundable		**-**		206,762
Total	**$**	**171,882**	$	699,251

There was no impairment of trade and other receivables during the year ended September 30, 2022 (2021 – $nil).

The following table presents changes in unbilled receivables:

		September 30, 2022		September 30, 2021
Balance, beginning of year	**$**	**308,728**	$	-
Revenue billed during the year		**(308,728)**		
Revenue in excess of billings, net of amounts transferred to trade accounts receivable		**8,881**		308,728
Amounts written off		**-**		-
Balance, end of year	**$**	**8,881**	$	308,728
Current	**$**	**8,881**	$	308,728
Non-current	**$**	**-**	$	-

(Expressed in Canadian dollars, except share amounts)

6. Inventories

The following table presents a breakdown of our inventories:

	September 30, 2022	September 30, 2021
Finished goods	**$ 49,643**	$ -
Work-in-progress	**21,350**	-
Raw materials	**322,545**	90,299
Total	**$ 393,538**	$ 90,299

There was no impairment of inventories during the year ended September 30, 2022 (2021 – $nil).

7. Property and equipment

The following is summary of changes in our property and equipment:

Cost	Computer equipment	Computer software	Office furniture and equipment	LRIP equipment[(1)]	R&D equipment	Leasehold improvements	Sales demo equipment	Total
Balance, September 30, 2020	$ 32,807	$ 8,145	$ 81,841	$ -	$ 53,634	$ 59,090	$ -	$ 235,517
Additions	30,778	-	11,211	-	165,030	58,147	548,626	813,792
Disposals	(3,828)	(8,145)	(2,936)	-	(724)	-	-	(15,633)
Balance at September 30, 2021	$ 59,757	$ -	$ 90,116	$ -	$ 217,940	$ 117,237	548,626	$ 1,033,676
Additions	50,849	5,129	10,817	77,559	21,864	19,800	1,460	187,478
Disposals	(3,800)	-	-	-	-	-	-	(3,800)
Balance at September 30, 2022	**$ 106,806**	**$ 5,129**	**$ 100,933**	**$ 77,559**	**$ 239,804**	**$ 137,037**	**$ 550,086**	**$ 1,217,354**

Accumulated depreciation	Computer equipment	Computer software	Office furniture and equipment	Moulding equipment	R&D equipment	Leasehold improvements	Sales demo equipment	Total
Balance, September 30, 2020	$ 6,062	$ 7,637	$ 22,292	$ -	$ 20,837	$ 4,045	-	$ 60,873
Depreciation for the year	13,966	508	18,759	-	17,462	12,489	16,444	79,628
Disposals	(1,630)	(8,145)	(687)	-	(12)	-	-	(10,474)
Balance at September 30, 2021	$ 18,398	$ -	$ 40,364	$ -	$ 38,287	$ 16,534	16,444	$ 130,027
Depreciation for the year	26,762	1,254	19,067	7,002	46,219	27,915	129,262	257,481
Disposals	(2,635)	-	-	-	-	-	-	(2,635)
Balance at September 30, 2022	**$ 42,525**	**$ 1,254**	**$ 59,431**	**$ 7,002**	**$ 84,506**	**$ 44,449**	**$ 145,706**	**$ 384,873**
Carrying value at September 30, 2021	$ 41,359	$ -	$ 49,752	$ 49,752	$ 179,653	$ 100,703	$ 532,182	$ 903,649
Carrying value at September 30, 2022	**$ 64,281**	**$ 3,875**	**$ 41,502**	**$ 70,557**	**$ 155,298**	**$ 92,588**	**$ 404,380**	**$ 832,481**

(1) Low-rate initial production equipment ("LRIP") includes moulds for developing PARA OPS™ device samples.

8. Right-of-use assets

The following table presents our right-of-use assets:

	Offices	Printer	Total
Balance at September 30, 2020	324,297	3,279	327,576
Depreciation	(58,083)	(3,279)	(61,362)
Balance at September 30, 2021	$ 266,214	$ -	$ 266,214
Depreciation	(58,083)	-	(58,083)
Balance at September 30, 2022	**$ 208,131**	**$ -**	**$ 208,131**

(Expressed in Canadian dollars, except share amounts)

In connection with our current lease, we made a total deposit of $33,726 to be released only at the end of this lease. This was initially recorded at fair value, discounted using the implied interest rate in the lease. At September 30, 2022, $23,604 (2021 - $21,367) was the carrying value and reported as non-current deposit in the consolidated statements of financial position.

9. Intangible assets

The following table shows a breakdown of our intangible assets:

Cost	TASCS System	Phantom™ System	PARA OPS™ System	PARA OPS™ Patent	ARWEN™ Tradename	Customer Relationships	Purchase Orders	Total
Balance at September 30, 2020	$ 163,230	$ 481,472	$ -	$ -	$ -	$ -	$ -	$ 644,702
Additions	-	83,228	-	-	-	-	-	83,228
Acquisition (Note 4(b))	-	-	2,906,219	-	-	-	-	2,906,219
Transferred to cost of sales	(107,854)	-	-	-	-	-	-	(107,854)
Impairment charge	(55,376)	-	-	-	-	-	-	(55,376)
Balance at September 30, 2021	$ -	$ 564,700	$ 2,906,219	$ -	$ -	$ -	$ -	$ 3,470,919
Additions	-	584,885	562,996	28,783	-	-	-	1,176,664
Acquisition (Note 4(a))	-	-	-	-	44,000	50,000	100,000	194,000
Amortization	-	-	-	-	(6,968)	(3,959)	-	(10,927)
Recognition of open orders	-	-	-	-	-	-	(87,802)	(87,802)
Balance at September 30, 2022	**$ -**	**$ 1,149,585**	**$ 3,469,215**	**$ 28,783**	**$ 37,032**	**$ 46,041**	**$ 12,198**	**$ 4,742,854**

The balance at September 30, 2022 for Phantom™ and PARA OPS™ represents the acquired technology asset (i.e. intellectual properties), coupled with additional capitalized development costs. As both product lines have not yet reached commercialization, no amortization charge was recorded for the year ended September 30, 2022 (2021 - $nil). Management anticipates the estimated useful life to be five years for both technology assets subsequent to the expected commercialization date and the estimated useful life of the patent will be determined subsequent to the approval of the patent.

In connection with Police Ordnance Acquisition (see Note 4(a)), we have recorded the following intangible assets at fair value: ARWEN™ tradename, customer relationships and open purchase orders. During the year ended September 30, 2022, we have delivered on most open purchase orders resulting in a decrease of $87,802. Management has estimated the useful lives of tradename and customer relationships of five and ten years, respectively.

10. Accounts payable and accrued liabilities

The following table presents a breakdown of our accounts payable and accrued liabilities:

	September 30, 2022	September 30, 2021
Trade payable	**$ 2,292,954**	$ 620,041
Accrued liabilities	**1,045,409**	384,239
Salary, bonus and vacation payable	**1,116,203**	122,230
Interest payable	**4,915**	-
Payroll taxes payable	**-**	692
Total	**$ 4,459,481**	$ 1,127,202

11. Related party transactions

Key management personnel compensation

Key management personnel are those having authority and responsibility for planning, directing and controlling the activities of KWESST directly or indirectly, including any of our directors (executive and nonexecutive).

(Expressed in Canadian dollars, except share amounts)

Our key management personnel are the executive management team and Board of Directors, who collectively control approximately (28.3%) of the issued and outstanding common shares of KWESST at September 30, 2022 (2021 – 31.5%, 2020 – 38.0%).

Key management personnel compensation comprised the following:

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
Wages and benefits	**$ 641,338**	$ 427,252	$ 165,769
Consulting fees	**529,529**	180,000	145,000
Directors compensation	**70,000**	85,000	-
Share-based compensation	**860,400**	988,716	24,959
Total	**$ 2,101,267**	$ 1,680,968	$ 335,728

The consulting fees relate to compensation to our Executive Chairman (via his private corporation, DEFSEC Corp), including a bonus for the year ended September 30, 2022, which was approved by our Board of Directors and paid only after the U.S. IPO and Canadian Offering (see Note 27(a)). It also includes consulting fees payable to an independent director for advisory services relating to PARA OPS™.

Related party loans

For the year ended September 31, 2022, we did not enter into any related party loans. The following table summarizes the changes in related party loans in the prior year.

	CEO loan	**Employee loan**	**Total**
Balance, September 30, 2020	$ 207,092	$ 11,184	$ 218,276
Accrued interest	4,513	68	4,581
Repayment of loans	(211,605)	(11,252)	(222,857)
Balance, September 30, 2021	**$ -**	**$ -**	**$ -**

The CEO and employee loans accrued interest at TD Bank prime plus 1.55% and 5%, respectively.

Other related party transactions:

- In April 2021, two directors and the CFO of KWESST participated in the brokered private placement (see Note 15(a)); collectively, they purchased 1,029 Units for a total consideration of $90,000. This transaction was recorded at fair value.
- In March 2022, two directors, the Executive Chairman, and the CFO of KWESST participated in the March 2022 Loans for an aggregate amount of $74,000 and received a total of 529 bonus common shares (see Note 12).
- In July 2022, one director, the Executive Chairman, and the CFO of KWESST participated in the July 2022 Offering (see Note 15(a)); collectively, they purchased 5,813 Units for a total consideration of $87,500. This transaction was recorded at fair value.
- In August 2022, our Executive Chairman and CFO advanced a total of $60,000 to KWESST for employee payroll purposes. This advance was repaid on August 30, 2022.

At September 30, 2022 there was $672,531 outstanding amount in accounts payable and accrued liabilities due to our officers and directors for unpaid wages, bonuses, director fees and expense reimbursements.

(Expressed in Canadian dollars, except share amounts)

12. Borrowings

	CEBA Term Loans	February 2021 Loan	March 2022 Loans	August 2022 Loans	Total Borrowings
Balance, September 30, 2020	$ 32,273	$ -	$ -	$ -	$ 32,273
Additional borrowings	20,000	306,000	-	-	326,000
Gain on government grant	(3,514)	-	-	-	(3,514)
Accrued interest	4,492	4,527	-	-	9,019
Repayment	-	(310,527)	-	-	(310,527)
Balance, September 30, 2021	$ 53,251	$ -	$ -	$ -	$ 53,251
Assumed from acquisition (Note 4)	26,238	-	-	-	26,238
Issuance at fair value	-	-	1,634,283	475,591	2,109,874
Deferred financing fees	-	-	(74,055)	(76,354)	(150,409)
Net borrowings	79,489	-	1,560,228	399,237	2,038,954
Adjustment	(5,496)	-	-	-	(5,496)
Accrued interest and accretion expense	4,803	-	304,922	11,588	321,313
Foreign exchange loss	-	-	-	24,523	24,523
Interest paid	-	-	(100,520)	-	(100,520)
Balance, September 30, 2022	**$ 78,796**	**$ -**	**$ 1,764,630**	**$ 435,348**	**$ 2,278,774**
Current	$ -	$ -	$ 1,764,630	$ 435,348	$ 2,199,978
Non-current	78,796	-	-		$ 78,796
Total	**$ 78,796**	**$ -**	**$ 1,764,630**	**$ 435,348**	**$ 2,278,774**

<u>August 2022 Loans</u>

On August 25, 2022, we closed two unsecured loans in the amount of USD$200,000 per loan with a third-party lender ("Lender") for an aggregate amount of USD$400,000 (the "August 2022 Loans").

The August 2022 Loans bear interest at a rate of 6.0% per annum, compounded monthly and not in advance, and have a maturity of twelve months, with KWESST having the option to repay the whole or any part of the August 2022 Loans, without penalty or premium, at any time prior to the close of business on the maturity date. On repayment of the August 2022 Loans, we will pay 110% of the principal amount plus accrued interest on the August 2022 Loans. As part of the terms of one of the August 2022 Loans, we issued an aggregate of 4,239 common shares to the Lender (the "Bonus Shares"), being an amount equal to twenty percent (20%) of USD$200,000, converted to CAD$ at an exchange rate of $1.2983, divided by the market price of our common shares on the TSX-V at market close on August 24, 2022, being $12.25. The Bonus Shares were issued in accordance with applicable prospectus exemptions under Canadian securities laws.

As a result of issuing common shares and debt for the first loan of USD$200,000 (or $260,698), we allocated the gross proceeds to these two financial instruments based on their relative fair value. To measure the fair value of the loan, we used the income approach and estimated a market discount rate of 24% to discount the future cash flows of the loan resulting in an estimated fair value of $214,893. Accordingly, we allocated $214,893 of the $260,698 to the first loan and $45,804 to share capital for the bonus common shares issued (see Note 15(a)).

Concurrently with the closing of the August 2022 Loans, our Executive Chairman and President and Chief Executive Officer (the "KWESST Principals") entered into call option agreements with the Lender whereby the Lender will have the option, pursuant to the terms and conditions of the call option agreements, to purchase 10,591 common shares held by the KWESST Principals at a price of $12.25 for a period of five years. Additional free-trading common shares may be offered by the KWESST Principals to the Lender should we elect to proceed with a share-for-debt transaction in connection with one of the Loans. KWESST is not a party to the call option agreements.

In connection with the August 2022 Loans, we paid a cash finder's fee to a third-party intermediary in an amount of USD$32,000.

March 2022 Loans

On March 11, 2022, we closed a unsecured loan financing with various lenders in an aggregate amount of $1,800,000 and an additional $200,000 on March 15, 2022, for a total of $2,000,000 (the “March 2022 Loans”). Certain directors and officers participated in this financing for an aggregate amount of $74,000. The March 2022 Loans bear interest at a rate of 9.0% per annum, compounded monthly and not in advance, and have a maturity of thirteen months, with KWESST having the option to repay the whole or any part of the March 2022 Loans, without penalty or premium, at any time prior to the close of business on the maturity date. The principal amount is due only at maturity. As part of the terms of the March 2022 Loans, we issued an aggregate of 14,286 bonus common shares to the lenders.

As a result of issuing common shares and debt for a total combined cash consideration of $2,000,000, we allocated the gross proceeds to these two financial instruments based on their relative fair value. To measure the fair value of the March 2022 Loans, we used the income approach and estimated a market discount rate of 22% to discount the future cash flows of the March 2022 Loans resulting in an estimated fair value of $1,634,112. Accordingly, we allocated $1,634,112 of the $2,000,000 to March 2022 Loans and $365,888 to share capital for the bonus common shares issued (see Note 12(a)).

The total offering costs were $90,636, $74,055 of which was allocated to deferred financing fees and $16,581 allocated to share offering costs. The deferred financing fees are recognized as a reduction of the gross borrowings to be accreted over the life of the March 2022 Loans as a financing cost and the share offering costs were recognized as a reduction to common shares.

As the March 2022 Loans mature in April 2023, we presented these as current borrowings in the consolidated financial position.

February 2021 Loan

On February 24, 2021, we entered into an unsecured loan agreement with a private fund managed by a KWESST shareholder to borrow $306,000 for general corporate purposes. The interest rate on this loan was 0.5% per month. On May 27, 2021, we repaid the loan, including accrued interest, for a total of $310,527.

CEBA Term Loans

In December 2020, the Canadian Federal Government amended the CEBA Term Loan program to increase the loan amount by $20,000 to $60,000. We borrowed $40,000 during the nine-month period ended September 30, 2020, and an additional $20,000 during the fiscal year ended September 30, 2021. As a result of the Police Ordnance Acquisition (see Note 4(a)), we assumed an additional CEBA Term Loan of $40,000 during fiscal year ended September 30, 2022.

The CEBA Term Loans are initially recorded at fair value, discounted based on our estimated incremental borrowing rate. This resulted in recording a gain on government grant of $3,514 for the year ended September 30, 2021 (2020 - $9,096).

Effective January 1, 2021, the CEBA Term Loans were automatically converted to a 2-year interest free term loan. This was further amended on January 12, 2022, where the government of Canada announced the repayment deadline for the CEBA Term Loans to qualify for partial loan forgiveness is being extended from December 31, 2022, to December 31, 2023, for all eligible borrowers in good standing. Repayment on or before the new deadline of December 31, 2023, will result in loan forgiveness of up to a third of the loans. Due to our financial condition at September 30, 2022 and 2021, we have not recorded the potential forgivable amount in the event we repay the CEBA Term Loans prior to December 31, 2023.

(Expressed in Canadian dollars, except share amounts)

RBC Credit Facility

We maintain corporate credit cards for our key employees and a foreign exchange line of credit with Royal Bank of Canada ("RBC"). To provide security, we entered into a cash collateral agreement for $30,000 and a general security agreement providing a first lien on all assets. The $30,000 was invested in a short-term guaranteed investment certificate.

See Note 27(c), Subsequent Events – Loan Repayments.

13. Lease obligation

We have entered into a long-term office lease contract which expires on April 30, 2026. The office lease includes the right to renew for an additional five years following its expiry. Management has not included the renewal option because it was deemed too uncertain whether we would renew at September 30, 2022.

Under the current office lease agreement, we have benefited from the following lease inducements:
- Free rent from inception (March 1, 2020) to November 1, 2020; and
- Free rent from November 1, 2021, to March 1, 2022.

The following table presents the movement in our lease obligation for the respective periods:

	Offices	Current Portion	Non-current portion
Balance, September 30, 2020	$ 352,037	$ 44,128	$ 307,909
Lease payments (including interest)	(78,000)	-	-
Interest expense	33,872	-	-
Balance at September 30, 2021	**$ 307,909**	**$ 32,288**	**$ 275,621**
Lease payments (including interest)	(62,400)	-	-
Interest expense	30,112	-	-
Balance at September 30, 2022	**$ 275,621**	**$ 69,150**	**$ 206,471**

The following table presents the contractual undiscounted cash flows for the lease obligations:

	September 30, 2022	September 30, 2021
Less than one year	**$ 93,600**	$ 62,400
One to five years	**234,000**	327,600
Total	**$ 327,600**	$ 390,000

14. Contract Liabilities

The following table presents the changes in contract liabilities:

	September 30, 2022	September 30, 2021
Balance, beginning of fiscal year	**$ -**	$ 7,053
Acquired in acquisition of POC (see Note 4(a))	**29,759**	-
Amounts invoiced and revenue deferred	**17,512**	-
Recognition of deferred revenue included in the balance at the beginning of period	**-**	(7,053)
Balance, end of fiscal year	**$ 47,271**	$ -

(Expressed in Canadian dollars, except share amounts)

15. Share capital and Contributed Surplus

As disclosed in Note 1(b), the 1-for-70 Reverse Split effected on October 28, 2022, has been applied retrospectively herein.

a) Share capital

Authorized

KWESST is authorized to issue an unlimited number of common shares.

Issued Common Shares

	September 30, 2022		September 30, 2021		September 30, 2020	
	Number	Amount	Number	Amount	Number	Amount
Balance, beginning of year	699,511	$ 17,215,068	589,518	$ 9,374,563	383,996	$ 2,284,353
Issued in private placement	22,857	$ 272,000	10,714	$ 1,110,000	49,811	$ 1,480,875
Issued for exercise of warrants	19,000	$ 277,098	10,380	$ 815,307	-	$ -
Issued for bonus shares relating to borrowings (Note 10)	18,525	$ 411,692	-	$ -	-	$ -
Issued for conversion of share units	8,349	$ 874,840	138	$ 12,498	-	$ -
Issued for acquisition (Note 4(a))	3,965	$ 377,503	-	$ -	-	$ -
Issued for conversion of contingent shares (Note 4(a))	875	$ 83,319	-	$ -	-	$ -
Issued for debt settlements	143	$ 19,000	1,305	$ 63,866	-	$ -
Issued in brokered private placement	-	$ -	51,087	$ 3,611,818	62,994	$ 3,087,138
Issued for exercise of stock options	-	$ -	18,195	$ 1,292,015	1,743	$ 78,080
Issued for asset acquisition (Note 4(b))	-	$ -	14,286	$ 1,290,000	9,957	$ 167,280
Issued for exercise of broker compensation options	-	$ -	2,459	$ 347,680	-	$ -
Issued for amended license (Note 26)	-	$ -	1,429	$ 137,000	-	$ -
Issued for conversion of 15% 2020 converted notes	-	$ -	-	$ -	45,858	$ 1,328,163
Issued for performance bonus	-	$ -	-	$ -	14,929	$ 731,500
Shares from Foremost's QT (Note 4(c))	-	$ -	-	$ -	12,836	$ 628,949
Issued for conversion of 10% 2019 converted notes	-	$ -	-	$ -	6,523	$ 255,718
Issued for consulting services	-	$ -	-	$ -	871	$ 32,393
Less: share offering costs for the year	-	$ (33,880)	-	$ (839,679)	-	$ (699,886)
Balance, end of year	**773,225**	**$ 19,496,640**	**699,511**	**$ 17,215,068**	**589,518**	**$ 9,374,563**

<u>2022 Activities</u>

Private Placement

On July 14, 2022, we closed a non-brokered private placement, resulting in the issuance of 22,857 units of KWESST ("July 2022 Units"), at a price of $15.05 per July 2022 Unit (the "Issue Price"), for aggregate gross proceeds of $344,000 (the "July 2022 Offering").

Each July 2022 Unit is comprised of one common share and seventy one-half common share purchase warrant (the "July 2022 Warrants"). Accordingly, we issued 800,000 Warrants exercisable at $0.285 each for a period of 24 months from the closing date. Each Warrant converts into 0.01428571 common shares or 70 warrants for one common share. There was no finder fee paid in this private placement.

Certain of our directors and officers (the "Insiders") purchased 5,814 Units for a total consideration of $87,500. The issuance of Units to the Insiders constitutes a related party transaction but is exempt from the formal valuation and minority approval requirements of Multilateral Instrument 61-101 - Protection of Minority Security Holders in Special Transactions ("MI 61-101") as KWESST's securities are not listed on any stock exchange identified in Section 5.5(b) of MI 61-101 and neither the fair market value of the units issued to the Insiders, nor the fair market value of the entire private placement, exceeds 25% of our market capitalization.

The securities were issued in accordance with applicable prospectus exemptions under Canadian securities laws.

Police Ordnance Acquisition

As disclosed in Note 4(a), we issued 3,965 common shares to the selling shareholders in December 2021 at the closing of the acquisition and an additional 875 common shares in April 2022 following the achievement of the financial milestone as defined in the share purchase agreement.

2021 Activities

Brokered Private Placement

In April 2021, we closed our over-subscribed brokered private placement, resulting in the issuance of 51,087 units ("Units") of KWESST, at a price of $87.50 per Unit (the "Issue Price"), for aggregate gross proceeds of $4,470,071 (the "April 2021 Offering"), as amended in August 2021.

Under the April 2021 Offering, we sold a total of 51,087 units at a price of $87.50 per Unit. Each Unit is comprised of one common share of the Company and seventy common share purchase warrants ("April 2021 Warrant"). Each April 2021 Warrant is exercisable to acquire 1/70 of a common share at a price of $1.75 each (70 warrants for one common share) for a period of 24 months from the closing of the April 2021 Offering ("Closing Date"). If at any time after four (4) months and one (1) day following the Closing Date, the trading price of KWESST common stock on the TSX Venture Exchange is equal to or exceeds $210.00 for a period of 10 consecutive trading days, as evidenced by the price at the close of market, we will be entitled to notify the holders of the April 2021 Warrants of its intention to force the exercise of the April 2021 Warrants. Upon receipt of such notice, the holders of April 2021 Warrants shall have 30 days to exercise the April 2021 Warrants, failing which the April 2021 Warrants will automatically expire. Our directors and officers purchased 1,029 Units for a total consideration of $90,000.

In connection with this Offering, management has concluded the Unit qualified as an equity instrument under IAS 32, *Financial Instruments: Presentation*. Furthermore, management used the residual method to allocate the $87.50 consideration between common shares and the April 2021 Warrants. Because the April 2021 Warrants include an accelerator provision for expiration, management used the Barrier option model to estimate the fair value of these April 2021 Warrants at $0.24 each (70 warrants for one common share). As a result, $70.70 of the $87.50 consideration was allocated to common shares and is reflected in the above table of outstanding common shares.

The total cash and non-cash share offering costs were $630,680 for the Offering, including cash commission of $288,405 paid to the Agents and $233,057 of Compensation Options granted to the Agents (see part (c) Contributed Surplus).

Asset Acquisition

In April 2021, following the closing of the brokered private placement, KWESST closed on the acquisition of the PARA OPS™ System technology resulting in the issuance of 14,286 common shares and 500,000 warrants (see Note 4(a)). Management estimated a fair value of $0.85 per warrant, using the Black-Scholes option model (see below – Warrants).

Private Placement

In September 2021, we closed a non-brokered private placement, resulting in the issuance of 10,714 units ("September Units") of KWESST, at a price of $140.00 per September Unit (the "Issue Price"), for aggregate gross proceeds of $1,500,000 (the "September 2021 Offering").

Under the September 2021 Offering, each September Unit is comprised of one common share and seventy Warrant Shares at a price of $2.35 for each 1/70 of a common share (70 warrants for one common share) for a period of 24 months from September 16, 2021 ("September 2021 Warrants"). If at any time after four months and one day following September 16, 2021, the trading price of KWESST common stock on the TSX-V is equal to or exceeds $322.00 for a period of 3 consecutive trading days, as evidenced by the price at the close of market, we will be entitled to notify the holders of Warrants of its intention to force the exercise of the Warrants. Upon receipt of such notice, the holders of Warrants shall have 30 days to exercise the Warrants, failing which the Warrants will automatically expire.

We paid cash commissions to Haywood Securities Inc. in the amount of $90,000 and granted 45,000 broker warrants ("September 2021 Broker Warrants"). Each September 2021 Broker Warrant is exercisable to acquire 1/70 of a common share at a price of $2.00 for a period of 24 months from the closing of the September 2021 Offering. Management estimated a fair value of $0.72 per warrant, using the Black-Scholes option model (see below – Warrants).

In connection with this private placement, management has concluded the September Unit qualified as an equity instrument under IAS 32, *Financial Instruments: Presentation*. Furthermore, management used the residual method to allocate the $140.00 consideration between the common share and the Warrant. Because the warrant includes an accelerator provision for expiration, management used the Barrier option model to estimate the fair value of these September 2021 Warrants at $0.52 each (70 warrants for one common share). As a result, $103.60 of the $140.00 consideration was allocated to common shares and is reflected in the above table of outstanding common shares at September 30, 2021.

The total cash and non-cash share offering costs were $130,730 for this private placement.

Amended License

In April 2021, we issued 1,429 common shares for the exclusivity with AerialX as disclosed in Note 26.

Debt for Equity Settlement

During the year ended September 30, 2022, we settled $19,000 of legal fees for 143 common shares.

During the year ended September 30, 2021, we settled the following liabilities with our common shares:

- $47,000 of legal fees for 816 common shares; and
- $16,866 of online advertising services for 346 common shares.

<u>2020 Activities</u>

Brokered Private Placements

In September 2020, KWESST closed a brokered private placement led by PI Financial Corp., resulting in the issuance of 62,994, at $49.01 each, for aggregate gross proceeds of $3,086,687. The total share offering costs were $325,887, settled in cash and warrants.

2020 Convertible Notes

In May 2020, KWESST Inc. closed on approximately $1.1 million gross proceeds from the issuance of unsecured convertible notes ("2020 Notes"), with automatic conversion upon a Liquidity Event including the listing of KWESST on the TSX-V. In connection with these 2020 Notes, the note holders earned interest at a rate of 15% per annum. Additionally, as an inducement, the note holders also received 25% of the principal amount in the form of KWESST common shares based on a stock price of $31.50, resulting in the issuance 8,583 at the QT.

In light of KWESST going public in September 2020, resulting in the automatic conversion of these 2020 Notes, management concluded that under IAS 38 the recognition of these 2020 Notes should be accounted for as equity and not debt. At the QT, these 2020 Notes were converted to 35,398 common shares. Because the 2020 Notes were treated as equity instruments, the total accrued interest of $59,112 was not recognized in the profit or loss. This accrued interest was converted to 1,877 common shares at QT. In connection with this private placement, KWESST incurred $58,065 of offering costs settled in cash and warrants.

Private Placements

In January 2020, KWESST closed a non-brokered private placement, resulting in the issuance of 37,500 common shares of KWESST, at $28.00 each, for aggregate gross proceeds of $1,050,000.

In March 2020, KWESST closed a non-brokered private placement, resulting in the issuance of 12,082 common shares of KWESST, at $35.00 each, for aggregate gross proceeds of $422,875.

In June 2020, KWESST closed a non-brokered private placement, resulting in the issuance of 229 common shares of KWESST, at $34.93 each, for aggregate gross proceeds of $8,000.

Performance Share Bonus

During the quarter ended September 30, 2020, KWESST settled performance bonuses in the form of 643 common shares. Additionally, KWESST awarded 7,143 common shares each to two M&A / capital market advisors for successfully assisting KWESST to complete a QT, in accordance with their respective consulting agreement.

Shares from Foremost

As part of the reverse acquisition, KWESST assumed 12,836 common shares previously issued by Foremost (see Note 4(b)).

2019 Convertible Notes

In September 2020, as a result of the completion of the QT (see Note 4 (c)) all the 2019 Convertible Notes and accrued interest were automatically converted to 6,523 common shares of KWESST.

Asset Acquisition

As disclosed in Note 4(c), KWESST issued 9,957 common shares to acquire the Phantom system technology.

(Expressed in Canadian dollars, except share amounts)

b) Warrants

The following reflects the warrant activities:

	September 30, 2022			September 30, 2021			September 30, 2020		
	Number of warrants		**Weighted average exercise price**	Number of warrants		Weighted average exercise price	Number of warrants		Weighted average exercise price
Outstanding, beginning of year	**13,901,640**	**$**	**0.74**	9,585,050	$	0.24	8,500,000	$	0.20
Issued	**1,000,000**	**$**	**0.57**	5,043,165	$	1.73	1,085,050	$	0.54
Exercised	**(1,330,000)**	**$**	**0.26**	(726,575)	$	1.05	-	$	-
Expired	**(154,484)**	**$**	**0.56**	-	$	-	-	$	-
Outstanding, end of year	**13,417,156**	**$**	**0.78**	13,901,640	$	0.74	9,585,050	$	0.24
Exercisable, end of year	**12,792,156**	**$**	**0.82**	12,901,640	$	0.75	8,835,050	$	0.22

As a result of the Reverse Split (see Note 1(b)), the warrant holder must exercise 70 warrants to receive one common share.

The following table provides additional information on the total outstanding warrants at September 30, 2022:

	Number outstanding		**Fair value** [(1)]	**Expiry Date**
Founders' warrants:				
Exercise price of $0.20	5,520,000	$	1,013	January 1, 2024
Exercise price of $0.20	1,900,000	$	18,865	June 14, 2024
GhostStep's warrants:				
Exercise price of $0.50	250,000	$	60,000	January 15, 2023
April 2021 equity financing:				
Exercise price of $1.75	3,274,657	$	785,918	April 29, 2023
Exercise price of $1.75	40,000	$	9,600	August 25, 2023
LEC's warrants (see Note 4(b)):				
Exercise price of $0.70	500,000	$	425,000	April 29, 2026
September 2021 equity financing:				
Exercise price of $2.35	750,000	$	390,000	September 16, 2023
Broker warrants:				
Exercise price of $1.75	137,499	$	33,000	April 29, 2023
Exercise price of $2.00	45,000	$	32,400	September 16, 2023
Acquisition of Police Ordnance (Note 4(a)):				
Exercise price of $1.72	200,000	$	132,000	December 15, 2024
July 2022 equity financing				
Exercise price of $0.285	800,000	$	72,000	July 14, 2024
	13,417,156	**$**	**1,959,796**	

(1) Fair value is calculated based on the grant date fair value and number outstanding at September 30, 2022. It does not represent the fair value at September 30, 2022.

The fair value for the warrants issued during the year ended September 30, 2022, was determined by the Black Scholes option pricing model using the following key inputs:

(Expressed in Canadian dollars, except share amounts)

		Acquisition of POC		July 2022 Warrants
Exercise Price	**$**	**1.72**	**$**	**0.285**
1/70 of stock price	$	1.36	$	0.215
Volatility		84.7%		90.5%
Dividend Yield		Nil		Nil
Risk-free interest rate		1.04%		3.12%
Expected life		3		2
Weighted average fair value per warrant	**$**	**0.66**	**$**	**0.09**

The fair value for the warrants issued during the year ended September 30, 2021, was determined by the following valuation models and key inputs:

	Barrier Option Model				Black-Scholes Option Model			
		April 2021 warrants		September 2021 warrants		September 2021 broker warrants		LEC warrants
Exercise Price	**$**	**1.75**	**$**	**2.35**	**$**	**2.00**	**$**	**0.70**
1/70 of stock price	$	1.01	$	2.14	$	2.14	$	0.40
Volatility		80%		80%		80%		0%
Dividend Yield		Nil		Nil		Nil		Nil
Risk-free interest rate		0.31%		0.26%		0.26%		69.00%
Barrier (accelerator on life of warrants)	$	3.00	$	4.60		N/A		N/A
Rebate	$	1.25	$	2.00		N/A		N/A
Expected life		2		1		1		0.85
Weighted average fair value per warrant	**$**	**0.24**	**$**	**0.52**	**$**	**0.72**	**$**	**0.85**

The fair value for the warrants issued during nine months ended September 30, 2020, was determined using the Black-Scholes option model using the following inputs:

		Warrants @ $0.40		Warrants @ $0.45		Warrants @ $0.70
1/70 of stock price	$	0.40	$	0.50	$	0.70
Volatility		68%		68%		67%
Dividend Yield		Nil		Nil		Nil
Risk-free interest rate		1.47%		0.27%		0.29%
Expected life		2		2		2
Estimated fair value per warrant	**$**	**0.15**	**$**	**0.20**	**$**	**0.26**

c) Contributed Surplus

Contributed surplus consists of issued broker compensation options at fair value, the cumulative amortized fair value of share-based compensation grants since inception, less amounts transferred to share capital for exercises. If outstanding options expire or are forfeited, there is no reversal of contributed surplus.

Broker Compensation Options

The April 2021 Offering was completed by PI Financial Corp., the lead agent and sole bookrunner (the "Lead Agent"), and other dealers (the "Agents"). As consideration for the services provided by the Agents in connection with the April 2021 Offering, the Agents received: (a) a cash commission of $288,405; and (b) 3,296 compensation options (the "Compensation Options"). Each Compensation Option is exercisable to acquire one unit of KWESST (a "Compensation Option Unit") at a price equal to $87.50 for a period of two years after the closing of the Offering. Each Compensation Option Unit is comprised of one Common Share and seventy Common Share purchase warrants (a "Compensation Option Warrant"). Each Compensation Option Warrant is exercisable to acquire 1/70 of a Common Share (a "Compensation Option Warrant Share") at a price of $1.75 per Compensation Option Warrant Share (70 Compensation Option Warrant for one Compensation Option Warrant Share) for a period of 24 months from the closing of the Offering.

Based on the structure of the Compensation Option, management estimated its fair value using the Monte Carlo method. Management estimated a fair value of $77.00 per Compensation Option. The following were key inputs used in the Monte Carlo simulation: estimated life of 2 years, underlying stock price of $90.30, exercise price of Compensation Option of $87.50, exercise price of 70 Compensation Option Warrants of $87.50, estimated volatility of 80%, risk free rate of 0.31%, and discount for lack of marketability of 0%.

Accordingly, we recorded $233,057 of Compensation Options in contributed surplus, with an equal offset to share offering costs (a non-cash transaction).

During the year ended September 30, 2021, the Agents have exercised 2,459 Compensation Option Units for total gross proceeds of $215,148. At September 30, 2022, the total outstanding Compensation Option Units was 837.

Share-based compensation

On March 31, 2022, our shareholders approved the amended Company's Long-Term Incentive Plan (the "LTIP") to retain a competitive compensation structure for its directors, executives, employees, consultants, and service providers. The LTIP allows for the issuance of stock options ("Options"), restricted share units ("RSUs"), deferred share units ("DSUs"), share appreciation rights ("SARs"), and performance stock units ("PSUs") – collectively referred as Compensation Securities.

Under the LTIP, the aggregate maximum number of common shares available for issuance from treasury at any given time shall not exceed 10% of the outstanding common shares as of the date of Compensation Securities, subject to adjustment or increase of such number pursuant to the terms of the LTIP. Any Options that have been cancelled, repurchased, expired, or exercised will again be available under the LTIP. The maximum number of common shares issuable under the LTIP in respect RSUs, DSUs, SARs, and PSUs (herein referred as "Share Units") shall not exceed 60,382 shares. The LTIP is subject to annual shareholder approval at the Annual General and Special Meeting.

(i) Stock Options

At September 30, 2022, there were 19,833 stock options available for grant under our LTIP.

The following is summary of changes in outstanding stock options for the respective periods:

(Expressed in Canadian dollars, except share amounts)

	Number of options		Weighted average exercise price
Outstanding at December 31, 2019	-	$	-
Granted	29,357	$	45.50
Options from the Qualifying Transaction	1,224	$	32.90
Exercised	(1,743)	$	35.00
Outstanding at September 30, 2020	28,838	$	45.50
Granted	52,988	$	104.30
Exercised	(18,194)	$	50.40
Cancelled	(4,096)	$	48.30
Outstanding at September 30, 2021	59,536	$	95.90
Granted	9,500	$	69.59
Cancelled	(11,928)	$	131.76
Outstanding at September 30, 2022	**57,108**	**$**	**83.87**
Options exercisable at September 30, 2022	**43,618**	**$**	**83.90**

During the year ended September 30, 2022, we granted 9,500 (2021 – 52,988, 2020 – 29,357) options at a weighted average exercise price of $69.59 (2021 – $104.30, 2020 – $45.50). At September 30, 2022, the weighted average remaining vesting period was 0.88 years (2021 – 1.82 years, 2020 – 0.87).

For the options granted during the year ended September 30, 2022, the per share weighted-average fair value of stock options was $38.21 (2021 – $50.40, 2020 – $16.10), using the Black-Scholes option model with the following weighted-average assumptions:

	2022	2021	2020
Stock price	$14.70 to $126.70	$49.00 to $159.60	$28.00 to $49.00
Exercise price	$14.70 to $126.70	$49.00 to $159.60	$28.00 to $49.00
Volatility	90.48%	76.46%	67.71%
Dividend yield	Nil	Nil	Nil
Risk-free interest rate	2.04%	0.35%	65.00%
Expected life (years)	2.91	2.26	3.38
Weighted-average fair value per option	**$ 38.21**	**$ 50.40**	**$ 16.10**

The following table summarizes information about stock options outstanding at September 30, 2022:

Range of exercise prices	Number outstanding	Weighted average remaining contractual life		Weighted average outstanding strike price	Exercisable	Remaining exercisable contractual life		Weighted average exercisable strike price
$14.70 to $41.16	4,592	4.54	$	15.91	306	0.71	$	32.90
$41.17 to $67.63	12,329	2.74	$	48.74	12,329	2.74	$	48.74
$67.64 to $94.10	20,973	3.47	$	78.02	17,080	3.38	$	75.79
$94.11 to 120.57	7,448	3.34	$	118.59	7,448	3.34	$	118.59
$120.58 to $147.00	11,766	3.95	$	135.66	6,455	3.97	$	134.87
	57,108	**3.48**	**$**	**83.87**	**43,618**	**3.26**	**$**	**83.90**

(Expressed in Canadian dollars, except share amounts)

Amendment to stock option grants

For the year ended September 30, 2022, we had no amended stock option grants.

During the year ended September 30, 2021, our Board of Directors approved the acceleration of vesting for 5,507 options and the cancellation of 3,571 options. This contributed an additional stock-based compensation charge of $65,813 (included in the above total share-based compensation expenses).

(ii) Share Units

At September 30, 2022, there were 27,503 Share Units available for grant under our LTIP.

The following table shows the changes in Share Units:

	RSUs	PSUs	SARs	Total
Outstanding at September 30, 2020	-	-	-	-
Granted	16,412	2,857	2,143	21,412
Vested and converted	(139)	-	-	(139)
Outstanding at September 30, 2021	**16,273**	**2,857**	**2,143**	**21,273**
Granted	10,726	17,942	514	29,182
Vested and converted to common shares	(5,681)	(2,666)	-	(8,347)
Vested and repurchased for withholding taxe	(144)	(249)	-	(393)
Expired / cancelled	-	(17,714)	-	(17,714)
Outstanding at September 30, 2022	**21,174**	**170**	**2,657**	**24,001**

RSUs:

Each RSU entitles the holder to receive one common share in the future, based on continued service during the applicable period.

During the year ended September 30, 2022, we granted 10,726 RSUs (2021 - 16,412), with a weighted-average grant date fair value of $43.50 per unit (2021 – $105.70). The weighted average vesting period for the outstanding RSUs was 0.18 years at September 30, 2022 (2021 - 0.69 years).

PSUs:

Each PSU entitles the holder to receive one common share in the future, based on the achievement of established performance criteria and continued service during the applicable performance period.

During the year ended September 30, 2022, we granted 17,942 PSUs (2021 - 2,857), with a weighted-average grant date fair value of $126.70 per unit (2021 - $105.00). The outstanding PSUs were fully vested at September 30, 2022 (2021 - Weighted average vesting period was 0.40 years).

SARs:

Each SAR entitles the holder to receive cash or common share at our discretion in the future, based on continued service during the applicable period. The amount of the cash payment or the value of common shares is determined based on the increase of the share price of KWESST between the grant date and the exercise date. Because we intend to always settle in common shares, we account for SARs as equity-settled awards.

(Expressed in Canadian dollars, except share amounts)

During the year ended September 30, 2022, we granted 514 SARs (2021 - 2,143) at an exercise price of $126.70 (2021 - $115.50 each). The 514 SARs will expire on May 31, 2023 and 2,143 SARs will expire on January 22, 2024.

(iii) Share-based Compensation

For the year ended September 30, 2022, we recorded share-based compensation of $1,960,072 (2021 - $2,462,207, 2020 - $283,084).

The following table presents a breakdown of total share-based compensation expense by function:

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
General and administrative	**$ 1,104,858**	$ 1,425,111	$ 160,267
Selling and marketing	**552,627**	754,167	42,700
Research and development, net	**302,587**	282,929	80,117
Total share-based compensation	**$ 1,960,072**	$ 2,462,207	$ 283,084

16. Earnings (loss) per share

The following table summarizes the calculation of the weighted average basic number of basic and diluted common shares:

	Year ended Setpember 30, 2022	Year ended Setpember 30, 2021	Nine months ended Setpember 30, 2020
Issued common shares, beginning of year	699,511	589,518	383,996
Effect of shares issued from:			
Exercise of warrants	10,593	4,383	-
Issuance of bonus shares (Note 10)	8,262	-	-
Private placements	4,571	21,810	45,665
Conversion of stock units	3,703	31	-
Acquisition of Police Ordnance (Note 4(a))	3,144	-	-
Conversion of contingent shares (Note 4(a))	386	-	-
Debt settlements	132	1,038	-
Exercise of options	-	9,118	447
Asset acquisitions (Note 4(b))	-	6,027	1,272
Amended license agreement (Note 26)	-	626	-
Exercise of broker options	-	170	-
Conversion of convertible notes, including interest	-	-	7,126
Services rendered	-	-	1,373
Foremost's QT	-	-	752
Weighted average number of basic common shares	**730,302**	**632,721**	**440,631**
Dilutive securities:			
Stock options	-	-	-
Warrants	-	-	-
Weighted average number of dilutive common shares	**730,302**	**632,721**	**440,631**

At September 30, 2022 and 2021, all the stock options and warrants were anti-dilutive because of we incurred net loss for both fiscal years.

(Expressed in Canadian dollars, except share amounts)

17. Revenue

a) Revenue streams

KWESST generates revenue from the sale of products to its customers.

b) Disaggregation of revenue from contracts with customers

In the following table, revenue from contacts with customers is disaggregated by primary geographical market, major products and service lines, and timing of revenue recognition.

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
Major products / service lines			
Digitization	**$ 354,620**	$ 1,255,982	$ 835,097
Non-Lethal	**330,658**	-	-
Training and services	**34,590**	-	-
Other	**1,651**	19,822	26,820
	$ 721,519	$ 1,275,804	$ 861,917
Primary geographical markets			
United States	**$ 389,210**	$ 1,238,063	$ 835,097
Canada	**332,309**	37,741	26,820
	$ 721,519	$ 1,275,804	$ 861,917
Timing of revenue recognition			
Products and services transferred over time	**$ 389,210**	$ 1,238,063	$ 835,097
Products transferred at a point in time	**332,309**	37,741	26,820
	$ 721,519	$ 1,275,804	$ 861,917

Revenue allocated to remaining performance obligations represents contracted revenue that has not yet been recognized ("contracted not yet recognized") and includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods. At September 30, 2022, our contracted not yet recognized revenue was $625,177 (2021 - $16,545, 2020 - $233,193), of which 43% of this amount is expected to be recognized over the next 12 months with the remaining 57% expected to be recognized in 2 to 3 years.

For the year ended September 30, 2022, one customer accounted for the 41% revenue (2021 – one customer accounted for 95%, 2020 – two customers accounted for 61% and 35%, respectively).

(Expressed in Canadian dollars, except share amounts)

18. Expenses by nature

The following table presents a breakdown of expenses by nature for the following periods:

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
Employee benefits	$ 4,883,062	$ 4,746,316	$ 1,161,071
Advertising and promotion	1,352,750	1,914,630	220,946
Consulting fees	1,315,917	1,138,782	620,295
Professional fees	1,028,240	778,337	190,398
Travel and conferences	518,140	246,418	112,360
R&D consulting and material costs, net	420,378	482,348	100,483
Depreciation and amortization	326,491	140,990	103,397
Other expenses	266,822	252,961	106,006
Insurance	236,150	154,931	-
Transfer agent and listing fees	94,885	110,769	-
Royalty and license costs	-	287,000	-
M&A costs	-	-	1,561,860
Total expenses	10,442,835	10,253,482	4,176,816
Allocation to cost of sales:			
Employee benefits	(166,706)	(574,018)	(71,105)
Total operating expenses	$ 10,276,129	$ 9,679,464	$ 4,105,711

19. Depreciation and Amortization

The following table presents total depreciation and amortization expense of property and equipment, intangible assets, and right-of-use assets by function:

	2022	2021	2020
General and administrative	$ 123,960	$ 95,310	$ 89,307
Selling and marketing	129,265	16,443	-
Research and development	73,266	29,237	14,090
Total depreciation and amortization	**$ 326,491**	**$ 140,990**	**$ 103,397**

(Expressed in Canadian dollars, except share amounts)

20. Net finance costs

The following table presents a breakdown of net finance costs for the following periods:

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
Interest expense from:			
Unsecured loan	$ 321,313	$ 4,527	$ -
Accretion cost - accrued royalties liability	159,451	64,537	-
Lease obligations	30,112	33,872	31,242
Related party loans	-	4,581	8,448
CEBA term loan	-	4,481	-
2019 convertible notes	-	-	44,899
Other	1,114	4,115	5,885
Total interest expense	511,990	116,113	90,474
Interest income	(5,988)	(4,848)	(2,454)
Gain on termination of lease obligations	-	-	(17,527)
Gain on government grant	-	(3,514)	(9,096)
Net finance costs	$ 506,002	$ 107,751	$ 61,397

21. Income taxes

a) Income tax recovery

Income tax recovery is made up of the following components:

	Year end ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
Current income tax recovery (expense):	$ -	$ -	$ -
Deferred income tax (recovery) expense:	(49,442)	-	-
	$ (49,442)	$ -	$ -

b) Reconciliation of effective income tax rate

Our effective income tax rate differs from the statutory rate of 26.5% that would be obtained by applying the combined Canadian basic federal and provincial income tax rate to loss before income taxes. These differences result from the following:

(Expressed in Canadian dollars, except share amounts)

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
Loss before income taxes	**$ (10,569,732)**	$ (9,315,372)	$ (3,536,778)
Expected statutory tax rate	**26.5%**	26.5%	26.5%
Expected tax recovery resulting from loss	**(2,800,979)**	(2,468,574)	(937,246)
Increase (reduction) in income taxes resulting from:			
Non-deductible expenses	**563,842**	654,956	275,273
Foreign operations subject to different tax rates	**5,329**	3,593	-
Unrecognized temporary differences	**2,182,366**	1,826,279	661,973
Prior year differences	**-**	(16,254)	-
	$ (49,442)	$ -	$ -

KWESST claims research and development deductions and related Investment Tax Credits ("ITC") for tax purposes based on management's interpretation of the applicable legislation in the Income Tax Act of Canada. These claims are subject to audit by the Canada Revenue Agency ("CRA") and any adjustments that results could affect ITCs recorded in the consolidated financial statements. The following table shows the breakdown of R&D expenses, net of ITCs:

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
R&D expenses	**$ 2,064,493**	$ 2,369,145	$ 944,909
Less:			
Investment tax credits	**-**	(231,007)	(127,325)
R&D expenses, net	**2,064,493**	2,138,138	817,584

c) Deferred tax balances

The following tables deferred tax assets (liabilities) have been recognized in the consolidated financial statements:

	Balance at September 30, 2021	Arising on a business combination	Recognized in profit or loss	Balance at September 30, 2022
Deferred tax assets (liabilities):				
Net operating loss carryforwards	-	-	26,459	26,459
Intangibles and development costs	-	(49,442)	22,983	(26,459)
	-	(49,442)	49,442	-

(Expressed in Canadian dollars, except share amounts)

	Balance at September 30, 2020	Recognized in profit or loss	Recognized in Equity	Balance at September 30, 2021
Deferred tax assets (liabilities):				
Net operating loss carryforwards	48,045	(48,045)	-	-
Impairment provision	(48,045)	48,045	-	-
	-	-	-	-

	Balance at December 31, 2019	Recognized in profit or loss	Recognized in Equity	Balance at September 30, 2020
Deferred tax assets (liabilities):				
Net operating loss carryforwards	-	48,045	-	48,045
Impairment provision	-	(48,045)	-	(48,045)
	-	-	-	-

d) Unrecognized net deferred tax assets

Deferred taxes reflect the impact of loss carryforwards and of temporary differences between amounts of assets and liabilities for financial reporting purposes and such amounts as measured by enacted tax laws. However, KWESST has not recorded net deferred tax assets at September 30, 2022 and 2021 on the following deductible temporary differences, due to the uncertainty involved in determining whether these deferred tax assets will be realized upon expiration due to KWESST's limited history and cumulative operating losses since its inception.

The following is a summary of KWESST's unrecognized deductible temporary differences:

	Balance at September 30, 2022	Balance at September 30, 2021	Balance at September 30, 2020
Net operating loss carryforwards	18,589,894	9,429,436	4,279,494
Share issuance costs	1,298,783	1,810,927	1,496,239
Intangibles and development costs	608,705	780,607	-
Scientific research and development expenditures	1,583,058	1,789,571	218,235
Other	46,300	104,793	46,891
	22,126,741	13,915,334	6,040,859

e) Available net operating losses

At September 30, 2022, KWESST has the following net operating losses in Canada available to reduce future year's taxable income which expire as follows:

(Expressed in Canadian dollars, except share amounts)

Year of Expiry		Amount
2036	$	**512,163**
2037		**744,022**
2038		**1,174,797**
2039		**1,732,039**
2040 and thereafter		**14,526,720**
	$	**18,689,741**

f) Available research and development investment tax credits

The Company has the following research and development investment tax credits available to reduce future years' income taxes payable which expire as follows:

Year of Expiry		Amount
2037	$	**13,361**
2038		**6,742**
2039		**-**
2040 and thereafter		**328,480**
	$	**348,583**

22. Financial instruments

Fair value of financial instruments

The fair values of our cash, restricted short-term investment, trade and other receivables, accounts payable and accrued liabilities, deposit (included in non-current other assets), and related party loans approximate carrying value because of the short-term nature of these instruments.

Under IFRS, the levels of fair value hierarchy is as follows:

Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities;
Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
Level 3: inputs for the asset or liability that are not observable market data (unobservable inputs).

The lease deposit, lease obligations, accrued royalties liability, and borrowings were recorded at fair value at initial recognition. The fair value measurement for these were Level 2. Subsequently, these were measured at amortized cost and accreted to their nominal value over their respective terms. At September 30, 2022, the fair value for accrued royalties liability determined using a discount rate of 24% (2021 – 13.7%) would be $869,219 (2021 - $1,105,756). Using the same market discount rate, the fair value of the borrowings would be $68,750 at September 30, 2022 (2021 - $49,825).

Financial risk management

We are exposed to a number of financial risks arising through the normal course of business as well as through its financial instruments. Our overall business strategies, tolerance of risk and general risk management philosophy are determined by our Board of Directors in accordance with prevailing economic and operating conditions.

(a) Interest rate risk

Interest rate risk is the risk that the fair value of cash flows of a financial instrument will fluctuate because of changes in market interest rates. At September 30, 2022, our borrowings were all subject fixed interest rate and therefore these were not subject to interest rate risk. At September 30, 2021, our borrowing was interest free.

(b) Foreign currency risk

Foreign currency risk is the risk that the future cash flows or fair value of our financial instruments that are denominated in a currency that is not our functional currency will fluctuate due to a change in foreign exchange rates.

For the years ended September 30, 2022 and 2021, our revenue was substantially denominated in U.S. dollar driven by contracts with U.S. prime contractors in the defense sector. We also procure certain raw materials denominated in U.S. dollar for product development. Accordingly, we are exposed to the U.S. dollar currency. Where a natural hedge cannot be achieved, a significant change in the U.S. dollar currency could have a significant effect on our financial performance, financial position and cash flows. Currently, we do not use derivative instruments to hedge its U.S. dollar exposure.

At September 30, 2022, we had the following net U.S. dollar exposure:

	Total USD
Net liabilities in U.S. subsidiary	$ 34,623
US denominated:	
Assets	$ 70,187
Liabilities	(1,015,090)
Net U.S. dollar exposure	**$ (979,526)**
Impact to profit or loss if 5% movement in the U.S.	**$ (48,976)**

During the year ended September 30, 2022, we recorded foreign exchange gain of $28,780 (2021 – foreign exchange loss of $3,742; 2020 – foreign exchange loss of $13,937).

(c) Credit risk

Credit risk is the risk of financial loss to KWESST if a counterparty to a financial instrument fails to meet its contractual obligations. Our credit risk exposure is limited to cash, and trade and other receivables. Refer to Note 5 for the breakdown of our trade and other receivables. We enter into contracts with either large, financially sound global general contractors or law enforcement agencies, which mitigates the credit risk. At September 30, 2022, our trade receivable was $114,877 (2021 - $nil), of which $53,233 was overdue by more than 60 days from law enforcement agencies.

(d) Liquidity risk

Liquidity risk is the risk that we will be unable to meet our financial obligations as they become due. Our objective is to ensure that we have sufficient cash to meet our near-term obligation when they become due, under both normal and stressed condition, without incurring unacceptable losses or risking reputational damage to KWESST. A key risk in managing liquidity is the degree of uncertainty in our cash flows due to our early stage in operations and the need for additional capital to fund our business strategies (see Note 2(a)).

(Expressed in Canadian dollars, except share amounts)

At September 30, 2022, our contractual obligations were as follows:

Payment due:	Total	Within 1 Year	1 to 3 years	3 to 5 years
Accounts payable and accrued liabilities	**$ 4,459,481**	$ 4,459,481	$ -	$ -
Borrowings	**2,648,280**	2,548,280	100,000	-
Minimum royalty commitments	**2,500,000**	150,000	350,000	2,000,000
Lease obligations	**327,600**	93,600	187,200	46,800
Total contractual obligations	**$ 9,935,361**	**$ 7,251,361**	**$ 637,200**	**$ 2,046,800**

At September 30, 2022, we had $170,545 in cash and $5,409,487 in negative working capital (current assets less current liabilities). See Note 27 (a), *Subsequent Events – U.S. IPO and Canadian Offering*.

23. Supplemental cash flow information

The following table presents changes in non-cash working capital:

	Year ended September 30, 2022	Year ended September 30, 2021	Nine months ended September 30, 2020
Trade and other receivables	**$ 631,801**	$ (218,334)	$ (257,588)
Inventories	**49,446**	17,555	-
Prepaid expenses and other	**425,876**	(106,205)	(387,762)
Accounts payable and accrued liabilities	**2,515,289**	(828,698)	393,202
Contract liabilities	**17,410**	(7,053)	7,053
Deposits	**-**	150,000	-
Accrued royalties liability	**-**	1,191,219	-
	$ 3,639,822	$ 198,484	$ (245,095)

The following is a summary of non-cash items that were excluded from the consolidated statements of cash flows for the nine months ended September 30, 2022:

- $83,319 fair value of 875 contingent shares settled via common shares (see Note 4(a));
- $19,000 debt settlement via common shares;
- $61,173 fair value of warrants exercised and transferred to share capital from warrants; and
- $125,000 for 250,000 warrants exercised in connection with the GhostStep™ acquisition in June 2020.

The following is a summary of non-cash items that were excluded from the consolidated statements of cash flows for the year ended September 30, 2021:

- $63,866 debt settlement via common shares;
- $125,000 for 250,000 exercised warrants in connection with the GhostStep™ acquisition in June 2020;
- $102,991 fair value of warrants exercised and transferred to share capital;
- $203,516 fair value of options exercised and transferred to share capital from contributed surplus;
- $1,715,000 fair value of common shares and warrants issued for the acquisition of the LEC System (Note 4(b)),
- $137,000 fair value of common shares issued for the amended and restated license agreement with AerialX (Note 26);
- $169,832 share offering costs relating to the Broker Compensation Options (Note 15(a)); and
- $3,828 non-cash consideration for computer equipment acquired.

(Expressed in Canadian dollars, except share amounts)

The following is a summary of non-cash items that were excluded from the consolidated statements of cash flows for the nine months ended September 30, 2020:

- $358,178 of right-of-use asset and lease obligations relating to the new office lease;
- $139,787 of right-of-use asset and $157,315 lease obligations de-recognized from KWESST's consolidated financial position relating to the former lease office;
- $347,280 of KWESST's common shares and warrants for the asset acquisition of GhostStep™ Technology;
- $255,718 of convertible notes, including accrued interest, settled in KWESST's common shares;
- $322,779 of share offering costs settled in KWESST's common shares;
- $41,155 of options adjustment due to QT (see note 4(c)); and
- $17,531 fair value of options exercised and transferred to KWESST's common shares.

24. Segmented information

Our Executive Chairman has been identified as the chief operating decision maker. Our Executive Chairman evaluates the performance of KWESST and allocates resources based on the information provided by our internal management system at a consolidated level. We have determined that we have only one operating segment.

At September 30, 2022 and 2021, all of our property and equipment are located in Canada, including the right-of-use assets.

25. Capital management

Our objective in managing our capital is to safeguard our ability to continue as a going concern and to sustain future development of the business. Our senior management is responsible for managing the capital through regular review of financial information to ensure sufficient resources are available to meet operating requirements and investments to support our growth strategy. Our Board of Directors is responsible for overseeing this process. From time to time, we could issue new common shares or debt to maintain or adjust our capital structure (see Note 27). KWESST is not subject to any externally imposed capital requirements.

KWESST's capital is composed of the following:

	September 30, 2022	September 30, 2021
Debt:		
Borrowings	**$ 2,278,774**	$ 53,251
Lease obligations	**275,621**	307,909
Equity:		
Share capital	**19,496,640**	17,215,068
Warrants	**1,959,796**	1,848,389
Contributed surplus	**3,551,330**	2,458,211
Accumulated other comprehensive loss	**(101,418)**	(8,991)
Accumulated deficit	**(25,909,239)**	(15,388,949)
Total capital	**$ 1,551,504**	$ 6,484,888

(Expressed in Canadian dollars, except share amounts)

26. Commitments and contingencies

AerialX Drone Solutions ("AerialX")

On April 5, 2021, we entered into an amended and restated licensing agreement with AerialX to gain exclusive rights to manufacture, operate, and use its drone for the C-UAS (Counter Unmanned Aerial Systems) market, specifically for the United States Department of Defense and Canada's Department of National Defence for a period of two years from the date upon which AerialX will meet certain technical milestones. In consideration for this exclusivity, we have issued 1,429 common shares to AerialX ("Exclusive License Shares"). Based on our closing stock price of $95.90 on April 23, 2021 (TSX-V approval date), the fair value for these shares was $137,000. We recorded the $137,000 fair value as a license cost for the year ended September 30, 2021, with an equal offset to our share capital.

In addition to the Exclusive License Shares, we also agreed to issue an additional 1,429 common shares upon AerialX achieving the technical milestones. For the years ended September 30, 2022 and 2021, AerialX has not delivered on the technical milestones and therefore no recognition was made.

Additionally, we also agreed to issue up to 4,286 common shares subject to achieving the following performance milestones:

# of Common Shares	Milestones
1,071	$3 million in sales
1,429	$9 million in sales
1,786	$18 million in sales

The amended and restated licensing agreement also changed the terms of the annual minimum royalty payment to AerialX. The initial minimum royalty payment is not due prior to the first anniversary year of the Prototype Date, which is defined under the agreement as the date upon which a functioning prototype is received by us.

Under this agreement, we will pay a royalty ranging from 8% to 15% of sales of AerialX technology, subject to the following minimum payments:

- 1st anniversary: $150,000
- 2nd anniversary: $200,000
- 3rd anniversary: $300,000
- 4th anniversary: $400,000
- 5th anniversary: $500,000

In accordance with the original agreement dated November 18, 2019, in the first quarter of Fiscal 2020 we made a payment of $150,000 as an advance for future royalty payments (the "Advance"). This Advance was recorded as a non-current deposit at December 31, 2019 and September 30, 2020. During the year ended September 30, 2021, management performed a recoverability review of all our financial assets, including this Advance. Management made the recoverability assessment on the Advance based on anticipated future sales of the licensed technology. Due to the lack of delivery of a functional prototype during the year ended September 30, 2021, management concluded the timing and volume of future sales of the licensed drone was too uncertain. Accordingly, we took a charge to net loss for the year ended September 30, 2021. This charge is included in general and administrative expenses in the consolidated statements of net loss and comprehensive loss. As at September 30, 2022, ArielX has not delivered a functional prototype and no further royalties have been paid.

Under the amended and restated licensing agreement, we will continue to have non-exclusive worldwide license. This agreement will expire on April 30, 2026.

27. Subsequent Events

a) U.S. IPO and Canadian Offering

On December 9, 2022, we closed an underwritten U.S. public offering (the "U.S. IPO") and an underwritten Canadian offering (the "Canadian Offering"). In the U.S. IPO, we sold 2,500,000 units at a public offering price of USD $4.13 per unit (the "Unit"), consisting of one share of common stock and one warrant to purchase one share of common stock ("Warrant"). The Warrants have a per share exercise price of USD $5.00, can be exercised immediately, and expire five years from the date of issuance. In connection with the closing of the U.S. IPO, the underwriter partially exercised its over-allotment option to purchase an additional 199,000 pre-funded common share purchase warrants and 375,000 warrants to purchase common shares. The underwriter has the right to exercise the balance of its over-allotment option within the 45-day period.

In the Canadian Offering, we sold 726,392 units, each consisting of one common share and one warrant to purchase one common share, at a price to the public of USD $4.13 per unit. The warrants will have a per common share exercise price of USD $5.00, are exercisable immediately and expire five years from the date of issuance.

The closing of the U.S. IPO and Canadian Offering resulted in aggregate gross proceeds of USD $14,145,000, before deducting underwriting discounts and offering expenses.

The common shares of KWESST and the Warrants sold in the U.S. IPO began trading on the Nasdaq Capital Market under the symbols "KWE" and "KWESW", respectively, on December 7, 2022.

ThinkEquity acted as sole book-running manager for the U.S. IPO and PI Financial acted as sole book-running manager for the Canadian Offering.

As consideration for the services provided in connection with the U.S. IPO, ThinkEquity received: (a) a broker-dealer cash commission of approximately US$835,000 equal to 7.5% of the gross offering proceeds of the U.S. Offering and (b) underwriter warrants (the "Underwriter Warrants") to purchase up to 134,950 common shares equal to 5% of the common shares and pre-funded common share purchase warrants issued under the U.S. Offering. Each Underwriter Warrant is exercisable to acquire one common share at a price of US$5.1625, exercisable as of June 4, 2023, and expiring December 4, 2027.

As consideration for the services provided in connection with the Canadian Offering, PI Financial received: (a) a cash commission of approximately US$210,000 equal to 7% of the gross proceeds of the Offering; and (b) 50,848 compensation options (the "Compensation Options") equal to 7% of the number of Units issued under the Canadian Offering. Each Compensation Option is exercisable to acquire one Canadian Unit at a price of US$4.13 for a period of two years after the closing of the Canadian Offering.

In addition to the above brokers' compensation, we also incurred US$2.3 million share offering costs for the U.S. IPO and Canadian Offering, of which $628,262 was incurred and deferred at September 30, 2022.

b) Shares for Debt Settlement

We have entered into share for debt arrangements with existing lenders, which closed on December 13, 2022, following TSXV's conditional approval. This resulted in issuing 56,141 Units to settle $12,000 of the March 2022 Loans and USD$223,321 of the August 2022 Loans, including unpaid accrued interest and 10% premium at maturity (the "Debt Settlements") – see Note 12. The terms of the Units are the same as the Units issued in the Canadian Offering (see part (a)).

The Units, as well as the common shares and Warrants, to be issued pursuant to the Debt Settlements will be subject to a four-month hold period pursuant to applicable securities regulations and the policies of the TSXV.

c) Loan Repayments

In December 2022, we have repaid the remaining $1,997,435 of the March 2022 Loans, including accrued unpaid interest, and USD$223,321 of the August 2022 Loans, including unpaid accrued interest and 10% premium at maturity. Following these loan repayments, there were no further outstanding loans.

In December 2022, we have repaid the CEBA Term Loans net of the total forgivable amount of $30,000.