Consolidated Financial Statements of

KWESST MICRO SYSTEMS INC.

Year ended September 30, 2021, and
Nine months ended September 30, 2020

(Expressed in Canadian Dollars)

KWESST MICRO SYSTEMS INC.

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INDEPENDENT AUDITORS' REPORT

To the Shareholders of KWESST Micro Systems Inc.:

Opinion

We have audited the consolidated financial statements of KWESST Micro Systems Inc. (the Entity), which comprise:

- the consolidated statement of financial position as at September 30, 2021
- the consolidated statement of net loss and comprehensive loss for the year then ended
- the consolidated statement of changes in shareholders' equity for the year then ended
- the consolidated statement of cash flows for the year then ended
- and notes to the consolidated financial statements, including a summary of significant accounting policies

(Hereinafter referred to as the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the consolidated financial position of the Entity as at September 30, 2021, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS).

Basis for Opinion

We conducted our audits in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the ***Auditors' Responsibilities for the Audit of the Financial Statements*** section of our report.

We are independent of the Entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada and we have fulfilled our other responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note 2(a) in the financial statements, which indicates that KWESST Micro Systems Inc. has incurred significant losses and negative operating cash flows from inception that have primarily been funded from financing activities.

As stated in Note 2(a) in the financial statements, these events or conditions, along with other matters as set forth in Note 2(a) in the financial statements, indicate that a material uncertainty exists that may cast significant doubt on the Entity's ability to continue as a going concern.

Our opinion is not modified in respect of this matter.

Other Matter - Comparative Information

We draw attention to Note 8 to the financial statements ("Note 8"), which explains that certain comparative information presented for the year ended September 30, 2020 has been adjusted. Note 8 explains the reason for the adjustment and also explains the adjustments that were applied to correct certain comparative information. Our opinion is not modified in respect of this matter.

The financial statements for the year ended September 30, 2020, excluding the adjustments that were applied to correct certain comparative information, were audited by another auditor who expressed an unmodified opinion on those financial statements on January 28, 2021.

As part of our audit of the financial statements for the year ended September 30, 2021, we also audited the adjustments that were applied to correct certain comparative information presented for the year ended September 30, 2020. In our opinion, such adjustments are appropriate and have been properly applied. Other than with respect to the adjustments that were applied to correct certain comparative information, we were not engaged to audit, review or apply any procedures to the financial statements for the year ended September 30, 2020. Accordingly, we do not express an opinion or any other form of assurance on those financial statements taken as a whole.

Other Information

Management is responsible for the other information. Other information comprises:

- the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions.

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit and remain alert for indications that the other information appears to be materially misstated.

We obtained the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions as at the date of this auditors' report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in the auditors' report.

We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards (IFRS), and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Entity's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

Auditors' Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
  The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.
- Provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group Entity to express an opinion on the financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

KPMG LLP

Chartered Professional Accountants, Licensed Public Accountants

The engagement partner on the audit resulting in this independent auditors' report is Will Stephen.

Ottawa, Canada
November 23, 2021

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Financial Position
At September 30, 2021 and September 30, 2020

In Canadian dollars	*Notes*	**September 30, 2021**	September 30, 2020
			(Adjusted - see Note 8)
ASSETS			
Cash		**$ 2,688,105**	$ 3,073,760
Restricted short-term investment	12	**30,000**	-
Trade and other receivables	5	**699,251**	480,917
Inventories	6	**90,299**	-
Prepaid expenses and other		**548,042**	441,837
Current assets		**4,055,697**	3,996,514
Property and equipment	7	**903,649**	174,644
Right-of-use assets	8	**266,214**	327,576
Deposit	8	**21,367**	19,341
Intangible assets	9	**3,470,919**	644,702
Other assets	26	**-**	150,000
Non-current assets		**4,662,149**	1,316,263
Total Assets		**$ 8,717,846**	$ 5,312,777
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Accounts payable and accrued liabilities	10	**$ 1,127,202**	$ 818,274
Lease obligations	13	**32,288**	44,128
Related party loans	11	**-**	218,276
Borrowings	12	**-**	32,273
Contract liabilities	14	**-**	7,053
Current liabilities		**1,159,490**	1,120,004
Accrued royalties liability	4(a)	**1,105,756**	-
Lease obligations	13	**275,621**	307,909
Borrowings	12	**53,251**	-
Non-current liabilities		**1,434,628**	307,909
Total Liabilities		**2,594,118**	1,427,913
Shareholders' Equity			
Share capital	16(a)	**17,215,068**	9,374,563
Warrants	16(b)	**1,848,389**	277,170
Contributed surplus	16(c)	**2,458,211**	306,708
Accumulated other comprehensive loss		**(8,991)**	-
Accumulated deficit		**(15,388,949)**	(6,073,577)
Total Shareholders' Equity		**6,123,728**	**3,884,864**
Total Liabilities and Shareholders' Equity		**$ 8,717,846**	**$ 5,312,777**

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
Year ended September 30, 2021 and nine months ended September 30, 2020

In Canadian dollars	***Notes***		**Year ended September 30, 2021**		Nine months ended September 30, 2020
					(Adjusted - see Note 8)
Revenue	18	**$**	**1,275,804**	$	861,917
Cost of sales			**(798,888)**		(247,113)
Gross profit			**476,916**		614,804
Operating expenses					
General and administrative	4(d)		**4,057,167**		2,723,861
Selling and marketing			**3,484,159**		564,266
Research and development, net	21(a)		**2,138,138**		817,584
Total operating expenses	19		**9,679,464**		4,105,711
Operating loss			**(9,202,548)**		(3,490,907)
Other income (expenses)					
Fair value adjustments on derivatives	22		**-**		29,463
Net finance costs	20		**(107,751)**		(61,397)
Foreign exchange loss			**(3,742)**		(13,937)
Loss on disposals			**(1,331)**		-
Total other expenses			**(112,824)**		(45,871)
Net loss		**$**	**(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			**(8,991)**		-
Total comprehensive loss		**$**	**(9,324,363)**	$	(3,536,778)
Net loss per share					
Basic and diluted		**$**	**(0.21)**	$	(0.11)
Weighted average number of shares outstanding					
Basic and diluted	17		**44,290,536**		30,844,129

See accompanying notes to consolidated financial statements.

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Changes in Shareholders' Equity
Year ended September 30, 2021 and nine months ended September 30, 2020

In Canadian dollars	Notes	Share capital	Warrants	Contributed surplus	Translation reserve	Deficit	Total Shareholders' Equity
Balance, December 31, 2019		$ 2,284,353	$ 21,050	$ -	$ -	$ (2,536,799)	$ (231,396)
Shares and warrants issued for cash	16(a),(b)	4,568,013	76,120	-	-	-	4,644,133
Shares for converted debt and interest	16(a)	1,583,881	-	-	-	-	1,583,881
Shares issued for performance incentive	16(a)	731,500	-	-	-	-	731,500
Shares from Foremost's QT	4(b)	628,949	-	41,155	-	-	670,104
Shares and warrants issued on asset acquisition	4(c)	167,280	180,000	-	-	-	347,280
Stock options exercised	16(c)	78,080	-	(17,531)	-	-	60,549
Shares for consulting services	16(a)	32,393	-	-	-	-	32,393
Share-based compensation	16(c)	-	-	283,084	-	-	283,084
Share offering costs	16(a)	(699,886)	-	-	-	-	(699,886)
Net loss	8	-	-	-	-	(3,536,778)	(3,536,778)
Balance, September 30, 2020 (adjusted)		$ 9,374,563	$ 277,170	$ 306,708	$ -	$ (6,073,577)	$ 3,884,864
Shares for debt settlements	16(a)	63,866	-	-	-	-	63,866
Warrants exercised	16(b)	815,307	(175,741)	-	-	-	639,566
Shares and warrants issued on asset acquisition	4(a)	1,290,000	425,000	-	-	-	1,715,000
Shares for amended license	26(a)	137,000	-	-	-	-	137,000
Shares and warrants issued for cash	16(a),(b)	4,721,818	1,280,654	-	-	-	6,002,472
Stock options and warrants exercised	16(c)	1,639,695	41,306	(531,263)	-	-	1,149,738
Share-based compensation	16(c)	-	-	2,462,207	-	-	2,462,207
Restricted share units vested	16(c)	12,498	-	(12,498)	-	-	-
Share offering costs	16(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**

See accompanying notes to consolidated financial statements.

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

In Canadian dollars	Notes	**Year ended September 30, 2021**	Nine months ended September 30, 2020
			(Adjusted - see Note 8)
OPERATING ACTIVITIES			
Net loss		**$ (9,315,372)**	$ (3,536,778)
Items not affecting cash:			
Depreciation and amortization	7, 8, 27	**140,990**	103,397
Impairment of intangible assets	9	**55,376**	-
Share-based compensation	16(c)	**2,462,207**	283,084
Shares issued for M&A adivsory and consulting services		**-**	763,893
Shares for amended license	26(a)	**137,000**	-
Fair value adjustments on derivative liabilities	22	**-**	(29,463)
Non-cash listing expense	4(b)	**-**	814,703
Net finance costs	20	**107,751**	61,217
Loss on disposals		**1,331**	-
Changes in non-cash working capital items	23	**198,484**	(245,095)
Interest paid		**(42,980)**	(6,612)
Cash used in operating activities		**(6,255,213)**	(1,791,654)
INVESTING ACTIVITIES			
Acquisition of property and equipment	7	**(809,964)**	(133,927)
Investments in intangible assets	9	**(83,228)**	(163,230)
Deposit for advanced royalties	4(a)	**(150,000)**	-
Deposit for long-term office lease		**-**	(38,212)
Purchase of restricted short-term investment	12	**(30,000)**	-
Acquisition of technology asset	4(c)	**-**	(134,192)
Cash acquired on closing of Foremost	4(b)	**-**	78,589
Cash flows used in investing activities		**(1,073,192)**	(390,972)
FINANCING ACTIVITIES			
Proceeds from the issuance of common shares and warrants	16(a)	**6,002,472**	4,355,171
Payments of share offering costs	16(a)	**(606,622)**	(164,716)
Proceeds from convertible notes	16(a)	**-**	1,081,504
Proceeds from borrowings	12	**326,000**	40,000
Repayment of borrowings	12	**(306,000)**	-
Repayments to related party loans	11	**(218,276)**	(80,000)
Repayments of lease obligations	13	**(44,128)**	(58,188)
Proceeds from exercise of warrants	16(b)	**680,872**	-
Proceeds from exercise of stock options	16(c)	**1,108,432**	61,000
Cash flows provided by financing activities		**6,942,750**	5,234,771
Net change in cash during the period		**(385,655)**	3,052,145
Cash, beginning of period		**3,073,760**	21,615
Cash, end of period		**$ 2,688,105**	$ 3,073,760

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

1. Corporate information

KWEEST Micro Systems Inc. (the "Company" or "KWESST") was incorporated on November 28, 2017, under the laws of the Province of British Columbia. The Company's registered office is located at 550 Burrard Street, Suite 2900, Vancouver, British Columbia, Canada. Its corporate office is located at Unit 1, 155 Terrence Matthews Crescent, Kanata, Ontario, Canada. It also has representative offices in the following foreign locations: Washington DC (United States), London (United Kingdom), and Abu Dhabi (United Arab Emirates).

KWESST develops and commercializes next-generation tactical systems. Key market segments and solutions addressed by KWESST technologies are: (i) breakthrough technology in non-lethal systems with broad application, including law enforcement and personal defence, (ii) modernized digitization of tactical forces for shared situational awareness and targeting, and (iii) counter-measures against threats such as drones, lasers and electronic detection.

KWESST's common stock is listed on the TSX-Venture Exchange ("TSX-V'') under the stock symbol of KWE and on the OTCQB® Venture Market under the stock symbol of KWEMF.

Following the closing of the Qualifying Transaction ("QT") pursuant to the policies of the TSX Venture Exchange ("TSX-V") - see Note 4 (b), KWESST changed its fiscal year end to September 30th from December 31st to be aligned with the U.S. government fiscal year, a key market for KWESST. Accordingly, these consolidated financial statements presented herein are for the fiscal year ended September 30, 2021, with comparatives for the nine months ended September 30, 2020.

2. Basis of preparation

(a) Going concern

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

As an early-stage company, KWESST has not yet reached commercial production of its products and has incurred significant losses and negative operating cash flows from inception that have primarily been funded from financing activities. KWESST incurred $9.3 million net loss and negative operating cash flows of approximately $6.3 million for the year ended September 30, 2021 (2020 - $3.5 million net loss and negative operating cash flows of $1.8 million; 2019 - $1.1 million net loss and negative operating cash flows of $1.1 million).

The Company's ability to continue as a going concern and realize its assets and discharge its liabilities in the normal course of business is dependent upon closing timely additional sales orders and the ability to raise additional debt or equity financing, if required. There are various risks and uncertainties affecting KWESST's future financial position and its performance including, but not limited to:

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

KWESST's 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 the Company's business plan could have a material adverse effect on the Company's financial condition and/or financial performance. There is no assurance that that the Company 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.

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 on November 23, 2021.

(c) Principles of consolidation

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

Control is achieved where KWESST has 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 the Company's 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 the Company 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, 2021, the Company has the following wholly-owned subsidiaries:

	Location	Equity %
KWESST Inc.	Kanata, Canada	100%
KWESST U.S. Inc.	Virginia, United States	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 except for certain financial instruments measured at fair value. Historical cost is generally based on the fair value of the consideration given in exchange for assets.

(f) Comparative figures

For the year ended September 30, 2021, KWESST changed the presentation of its expenses in the consolidated statements net loss and comprehensive loss from by nature to by function. KWESST made this change in presentation to provide more relevant financial information to facilitate peer benchmarking, particularly with peers in the United States. As a result, KWESST operating expenses are now presented as follows: general and administration ("G&A"), selling and marketing ("S&M"), and net research and development ("R&D").

G&A expenses consist of corporate personnel costs, various management and administrative support functions, insurance, regulatory and other public company costs, professional fees relating to corporate matters, corporate advisory consulting costs, M&A related costs, depreciation and amortization expenses, and occupancy costs related to G&A costs.

S&M expenses consist of business development costs related to the market development activities and product commercialization, marketing support function, depreciation and amortization expenses and investor relations support function.

R&D expenses consist of costs incurred in performing R&D activities, including new product development, continuous product development, materials and supplies, personnel costs, external engineering consulting, patent procurement costs, depreciation and amortization expenses, and occupancy costs related to R&D activity. These costs are net of Canadian investment tax credits for qualified Scientific Research and Experimental Development ("SR&ED") projects.

As this change constitutes a change in accounting policy, KWESST has restated the presentation of the comparative expenses to conform with the current year's expense presentation.

This resulted in no change to the previously reported total operating expenses for the nine months ended September 30, 2020. Refer to Note 19 for disclosure of expenses by nature.

(g) 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.

The current COVID-19 pandemic has significantly impacted health and economic conditions globally. While the COVID-19 has limited KWESST's ability to travel to foreign markets for business development during the year ended September 30, 2021, it has not significantly impacted KWESST's operations, including product development and delivery on customer contracts. However, impacts related to COVID-19 pandemic are expected to continue to pose risks to KWESST for the foreseeable future and could have a significant impact to KWESST's business, operations or financial performance in a manner that is difficult for management to predict.

<u>Judgments</u>

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 LEC 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 4(c) - acquisition of GhostStep® Technology: whether the fair value of KWESST's common shares and warrants issued was reasonable, and inputs used in accounting for the contingent annual payments.

- Note 16(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;

- Note 16(c) - *broker compensation options*: whether the Monte Carlo valuation model and number of simulations are reasonable to estimate the fair value of these options, coupled with the volatility assumption;

Estimates

Information about assumptions and estimation uncertainties at September 30, 2021 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 5 – *unbilled receivable*: estimated percentage of completion for determining revenue recognition and related unbilled receivable amount;
- Note 9 - *impairment test of intangible assets*: key assumptions underlying recoverable amounts; and
- Note 21 - *recognition of deferred tax assets:* availability of future taxable profits against which deductible temporary differences and tax losses carried forward can be utilized.

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 KWESST expects to receive in exchange for the products or services. KWESST's 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 KWESST 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, KWESST recognizes 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, KWESST 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.

KWESST 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, KWESST allocates 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).

KWESST accounts 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 that 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, KWESST recognizes 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) Financial instruments

KWESST recognizes 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.

<u>Financial assets</u>

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").

KWESST determines the classification of its 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 the Company changes its 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, 2021 KWESST 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, 2021 KWESST did not have financial assets classified as FVOCI or FVTPL.
Expected credit losses

KWESST measures a loss allowance based on the lifetime expected credit losses. Lifetime expected credit losses are estimated based on factors such as KWESST's 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.

Financial liabilities

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

KWESST determines the classification of its financial liabilities at initial recognition. The Company has classified the following as amortized costs:

- Accounts payable and accrued liabilities
- Related party loans
- Borrowings
- Lease obligations
- Convertible notes

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

At September 30, 2020, KWESST classified financial derivative liabilities as FVTPL. Accordingly, fair value is remeasured at each reporting period with the fair value adjustment recognized in profit or loss. There was no outstanding financial derivative liability at September 30, 2021.

For convertible notes, these are initially segregated into their debt and equity components or derivative liability components at the date of issue, in accordance with the substance of the contractual agreements. The conversion feature of the convertible notes is presumed to be classified as a derivative financial liability unless it meets all the criteria to recognize as equity instrument under IAS 32.

De-recognition of financial liabilities

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

(c) 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.

(d) 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 KWESST's property and equipment:

	Rate
Computer equipment	3 years
Computer software	3 years
Office furniture and 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, KWESST reviews 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.

(e) Leases

At inception of a contract, KWESST assesses 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.

KWESST recognizes 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 of 10% at the time. 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 KWESST is reasonably certain to exercise that option. Lease terms range from 3 to 6 years for offices and printer. 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, KWESST's 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 KWESST's estimate of the amount expected to be payable under a residual value guarantee, or if KWESST changes its 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.

KWESST has 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.

(f) 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 activities involve a plan or design for the production of new or substantially improved products and processes. 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 KWESST has 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) 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. KWESST recognizes 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 on site or 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.

(iv) 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.

(g) Provisions

A provision is recognized if, as a result of a past event, KWESST has 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 unwinding of the discount is recognized as a finance cost.

(h) 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 KWESST intends to settle its 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.

(i) 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.

(j) Share-based compensation

KWESST has a Long-Term Incentive Plan ("LTIP") in which it 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. KWESST measures 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 (see Note 16(c) for key inputs used in this 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.

(k) Foreign currency

Foreign currency transactions

The financial statements of KWESST and its Canadian wholly-owned subsidiary 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 U.S. Inc. 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.

(l) 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. KWESST uses 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.

(m) Reverse acquisition

KWESST was a capital pool company, which did not constitute a business as defined under IFRS 3 – *Business Combination* at the time of the QT and is therefore not within the scope of IFRS 3 (see Note 4(b)). However, the QT has some features of a reverse acquisition under IFRS 3. In the absence of a Standard that specifically applies to the QT, KWESST applied by analogy the guidance in IFRS 3 for reverse acquisitions in accordance with IAS 8 accounting policies, changes in accounting estimates and errors.

Application of the reverse acquisitions guidance by analogy results in the private operating entity KWESST Inc. being identified as the accounting acquirer, and the listed non-operating entity KWESST being identified as the accounting acquiree. The accounting acquirer is deemed to have issued shares to obtain control of the accounting acquiree KWESST. Because the QT is not within the scope of IFRS 3, KWESST accounted for it as an asset acquisition and the consideration as a share-based payment transaction which was accounted for in accordance with IFRS 2 – *Share-based Payment*.

According to IFRS 2, any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree's identifiable net assets represents a service received by the accounting acquirer. Regardless of the level of monetary or non-monetary assets owned by the non-listed operating entity, the entire difference was considered to be payment for a service of a stock exchange listing for its shares, and that no amount should be considered a cost of raising capital. The service received in the form of a stock exchange listing does not meet the definition of an intangible asset because it is not identifiable in accordance with IAS 38 Intangible Assets (it is not separable) and does not meet the definition of an asset that should be recognized in accordance with other Standards and the Conceptual Framework, therefore the services received was recognized as listing expense (included in merger & acquisition costs in the consolidated statements of net loss and comprehensive loss).

(n) 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.

New accounting standards issued

Amendments to IAS 8, Accounting Policies, Changes to Accounting Estimates and Errors

On February 12, 2021, the IASB issued amendments to IAS 8, Accounting Policies, Changes to Accounting Estimates and Errors, in which it introduces a new definition of "accounting estimates". These amendments are designed to clarify the distinction between changes in accounting estimate and changes in accounting policies and the correction of errors. Specifically, accounting estimates are now defined as "monetary amounts in financial statements that are subject to measurement uncertainty".

The amendments become effective for annual reporting periods beginning on or after January 1, 2023, with earlier application permitted. KWESST has early adopted these amendments for the year ended September 30, 2021, which resulted in no impact to its financial position, results of operations and cash flows.

4. Acquisitions

a) LEC System

On April 29, 2021, KWESST acquired the Low Energy Cartridge technology from DEFSEC, a proprietary non-lethal cartridge-based firing system (herein referred as the "LEC System"). This technology acquisition includes all intellectual property rights for the LEC System. With this acquisition, KWESST 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 KWESST's Executive Chairman, this asset acquisition is a related party transaction. KWESST 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.* However, KWESST obtained approval from over 51% disinterested shareholders as well as from the TSX-V prior to closing the acquisition.

The purchase consideration consisted of:

- 1,000,000 common shares of KWESST; and
- 500,000 warrants to purchase KWESST's common shares at $0.70 each; 25% vesting on the first anniversary of the closing of the LEC Technology acquisition and 25% per annum thereafter. These warrants will expire on April 29, 2026.

Additionally, KWESST will pay 7% royalty on annual sales of the LEC System to DEFSEC, net of taxes and duties, up to a maximum of $10 million, subject to minimum annual royalty payments starting in 2023. At closing of the acquisition, KWESST made an upfront payment of $150,000 as an advance on royalties owed for the first anniversary of the closing date.

(Expressed in Canadian dollars, except share amounts)

The following represents the future minimum annual royalty payments starting from the second anniversary of the closing date:

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 its sole discretion, KWESST may terminate this Agreement for convenience, including if market conditions for sales of the LEC System become unfavorable subject 60 day's prior written notice. Upon termination, KWESST will be fully released and discharged by DEFSEC including the outstanding future royalties and any unvested warrants shall be immediately cancelled. In return, KWESST will return all intellectual property rights relating to the LEC System to DEFSEC.

The purchase price was determined as follows:

	Number	Fair Value
Common shares	1,000,000	$ 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**

KWESST 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, 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, 2021, KWESST recorded $64,537 of accretion cost relating to the discounted minimum royalty payments, which is included in net finance costs (see Note 20).

(Expressed in Canadian dollars, except share amounts)

b) Reverse acquisition

On September 17, 2020, Foremost Ventures Corp. ("Foremost") completed the 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 4.67 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 41,266,176 shares of KWESST outstanding, of which 40,367,678 were held by the former shareholders of KWESST Inc. (representing approximately 97.8% of the outstanding shares of the Company) and 898,498 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		898,498
KWESST's stock price at closing of reverse acquisition (1)	$	0.70
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 4,409,553 KWESST Subscription Receipts issued at $0.70 per KWESST Subscription Receipt for gross proceeds of about $3.1 million before share issuance costs. See Note 16(a).

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, 1,000,000 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.

c) GhostStep® Technology

On June 12, 2020, KWESST acquired the GhostStep® Technology from SageGuild LLC ("SageGuild"). The GhostStep® Technology has since been rebranded by KWESST as the Phantom™, a tactical multi-function electromagnetic spectrum system. The Phantom™ System can generate numerous radio signals across multiple bands simultaneously, move itself around the battlefield, and function as a radio-relay while performing its main role of deception.

The purchase consideration consisted of:

(i) USD $100,000 (CAD $134,192) at closing;
(ii) 140,000 common shares of KWESST at closing; and
(iii) either the payment of USD $100,000 in cash or the issuance of 557,000 common shares of KWESST, at KWESST's sole discretion, upon the completion of KWESST's Qualifying Transaction ("QT").

In addition, KWESST agreed to:

(iv) make annual payments ("Yearly Payments") to SageGuild of $125,000 on each of December 31, 2020, 2021 and 2022, subject to certain conditions;
(v) issue 750,000 warrants to SageGuild exercisable at $0.50 per share and expiring on January 15, 2023 (the "SageGuild Warrants"); and
(vi) pay royalties up to USD $20 million.

The SageGuild Warrants will vest in equal tranches of 250,000 warrants on each of December 31, 2020, 2021 and 2022. KWESST has the right to apply the Yearly Payments against the exercise price of the Warrants. Further, in the event the consulting agreement with SageGuild is terminated, any remaining Yearly Payments will be terminated and the remaining unvested SageGuild Warrants will be cancelled. As the contingent Yearly Payments and SageGuild Warrants are directly linked, management combined these as "contingent consideration" for the purchase price allocation noted below. At December 31, 2020, KWESST issued 250,000 common shares for the 250,000 vested warrants (a non-cash transaction).

Additionally, KWESST will pay SageGuild royalties at a rate of 20% on amounts received in consideration of the grant of licenses and on sales of the Phantom™ System up to USD $3 million. Thereafter, the royalty rate will decrease to 5%. The obligation to pay royalties will terminate automatically once KWESST has paid SageGuild a total of USD $20 million in royalties. The Purchase Agreement became effective on June 12, 2020 and will continue in full force and effect until the earliest of (i) June 12, 2040 or (ii) the date of the expiration of the last of the patents or any of the patents (which are expected to be valid for a period of seventeen years from the date of issuance) related to improvements of the Phantom™ System to which SageGuild, or its principal Mr. Jeffrey M. Dunn, materially contributes, unless terminated earlier in accordance with the terms and conditions of the agreement.

In the event KWESST is in default of payment of any royalty payment as outlined above for a period of 30 days, SageGuild may terminate the agreement and KWESST will be required to, among other things, transfer the Phantom™ System back to SageGuild.

(Expressed in Canadian dollars, except share amounts)

The purchase price allocation was determined as follows:

	Number	Fair Value
Cash		$ 134,192
Common shares	140,000	$ 33,600
Cash or common share issuance (1)	555,700	$ 133,680
Contingent consideration		$ 180,000
Total		**$ 481,472**
Identifiable intangible assets		
Technology asset		**$ 481,472**

(1) In September 2020, KWESST elected to issue 557,000 common shares rather than to pay USD $100,000.

KWESST estimated the fair value as follows:

- *Common shares*: as KWESST was a private company at the time, there was no active market for its common shares. Management estimated the fair value of these shares based on the USD $100,000 cash or 557,000 common shares election available under the purchase agreement, which the two parties negotiated at arm's length. This implied a fair value of $0.24 per common share at the time of the closing of the asset acquisition.
- *Contingent consideration*: as previously noted above, the contingent consideration (Yearly Payments and SageGuild Warrants) is effectively future common share issuances subject to the consulting agreement with SageGuild remaining effective at each anniversary year (the service vesting period). Management assumed the entire 750,000 warrants will be converted to common shares over the next three years. Consistent with the above, management applied the estimated $0.24 per common share to the contingent 750,000 common shares issuance, for a total fair value of $180,000.

Because there is no minimum royalty payment under the Purchase Agreement, the future royalties were not included in the purchase price allocation. Royalties will be recognized at the time revenue is earned.

d) M&A costs

Included in KWESST's general and administrative costs are the following total M&A costs:

	Year ended September 30, 2021	Nine months ended September 30, 2020
Non-cash listing expense (1)	**$ -**	$ 814,703
Non-cash performance share bonus (1)	**-**	700,000
Professional fees	**10,041**	47,160
Total	**$ 10,041**	$ 1,561,863

1) Relates to the Reverse Acquisition transaction as noted in part (b)

(Expressed in Canadian dollars, except share amounts)

5. Trade and other receivables

The following table presents trade and other receivables for KWESST:

	September 30, 2021	September 30, 2020
		(Adjusted - see Note 8)
Trade receivables	$ -	$ 209,169
Unbilled revenue	308,728	-
Sales tax recoverable	183,761	144,423
Investment tax credits refundable	206,762	127,325
Total	**$ 699,251**	$ 480,917

There was no impairment of trade and other receivables during the year ended September 30, 2021 (2020 - $nil).

The following table presents changes in unbilled receivables:

	2021	2020
Balance, beginning of period	$ -	$ -
Revenue in excess of billings, net of amounts transferred to trade accounts receivable	308,728	-
Amounts written off	-	-
Balance, end of period	**$ 308,728**	$ -
Current	$ 308,728	$ -
Non-current	$ -	$ -

6. Inventories

The following table presents a breakdown of inventories:

	September 30, 2021	September 30, 2020
Raw materials	90,299	-
Total	**$ 90,299**	$ -

There was no impairment of inventories during the year ended September 30, 2021 (2020 – $nil).

(Expressed in Canadian dollars, except share amounts)

7. Property and equipment

The following is summary of changes in property and equipment for KWESST:

Cost	Computer equipment	Computer software	Office furniture and equipment	R&D equipment	Leasehold improvements	Sales demo equipment	Total
Balance, December 31, 2019	$ 14,073	$ 8,145	$ 32,781	$ 46,588	$ 8,607	$ -	$ 110,194
Additions	18,734	-	49,060	7,046	59,090	-	133,930
Disposals	-	-	-	-	(8,607)	-	(8,607)
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**

Accumulated depreciation	Computer equipment	Computer software	Office furniture and equipment	R&D equipment	Leasehold improvements	Sales demo equipment	Total
Balance, December 30, 2019	$ 241	$ 6,111	$ 16,143	$ 13,358	$ 4,219	$ -	$ 40,072
Depreciation for nine months	5,821	1,526	6,149	7,478	8,434	-	29,408
Disposals	-	-	-	-	(8,607)	-	(8,607)
Balance, September 30, 2020	$ 6,062	$ 7,637	$ 22,292	$ 20,836	$ 4,046	-	$ 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**	**$ 38,286**	**$ 16,535**	**$ 16,444**	**$ 130,027**
Carrying value at September 30, 2020	$ 26,745	$ 508	$ 59,549	$ 32,798	$ 55,044	$ -	$ 174,644
Carrying value at September 30, 2021	**$ 41,359**	**$ -**	**$ 49,752**	**$ 179,654**	**$ 100,702**	**$ 532,182**	**$ 903,649**

8. Right-of-use assets

The following table presents right-of-use assets for KWESST:

	Offices	Printer	Total
Balance at December 31, 2019	$ 177,911	$ 6,561	$184,472
Additions	571,604	-	571,604
Termination	(139,787)	-	(139,787)
Depreciation	(92,567)	(3,282)	(95,849)
Balance at September 30, 2020 (as previously reported)	517,161	3,279	520,440
Correction of an error	(192,864)	-	(192,864)
Balance at September 30, 2020 (as adjusted)	324,297	3,279	327,576
Depreciation	(58,083)	(3,279)	(61,362)
Balance at September 30, 2021	**$ 266,214**	**$ -**	**$266,214**

During the year ended September 30, 2021, management made an adjustment for a correction in the application of IFRS 16, *Leases*, to the new office lease entered in the prior year, whereby future variable payments were erroneously included in the calculation of the lease obligations. The following summarizes the effects of this correction to the prior year's comparatives.

(Expressed in Canadian dollars, except share amounts)

Consolidated statements of financial position as at September 30, 2020:

	Previously Reported	Adjustment	Adjusted
Trade and other receivables	$ 479,291	$ 1,626	**$ 480,917**
Right-of-assets	$ 520,440	$ (192,864)	**$ 327,576**
Deposit (non-current)	$ 22,337	$ (2,996)	**$ 19,341**
Total assets	$ 5,507,011	$ (194,234)	**$ 5,312,777**
Lease obligations (current)	$ 78,358	$ (34,230)	**$ 44,128**
Lease obligations (non-current)	$ 496,394	$ (188,485)	**$ 307,909**
Total liabilities	$ 1,650,628	$ (222,715)	**$ 1,427,913**
Deficit	$ (6,102,058)	$ 28,481	**$ (6,073,577)**

Consolidated statements of net loss and comprehensive loss for the nine months ended September 30, 2020:

	Previously Reported (1)	Adjustment	Adjusted
General and adminstrative expenses	$ 2,740,779	$ (16,918)	**$ 2,723,861**
Net finance costs	$ 72,960	$ (11,563)	**$ 61,397**
Net loss and comprehensive loss	$ (3,565,259)	$ 28,481	**$ (3,536,778)**

(1) Adjusted for the change in presentation – see Note 2(f).

Condensed consolidated interim statements of changes in shareholders' equity (deficit) for the nine months ended September 30, 2020:

	Previously Reported	Adjustment	Adjusted
Deficit	$ (6,102,058)	$ 28,481	**$ (6,073,577)**
Total shareholders' equity (deficit)	$ 3,856,383	$ 28,481	**$ 3,884,864**

In connection with the lease entered in the prior year, KWESST 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, 2021, $21,367 (2020 - $19,341) was the carrying value and reported as non-current deposit in the consolidated statements of financial position.

9. Intangible assets

The following table presents intangible assets for KWESST:

Cost	**TASCS System**	**Phantom™ System**	**LEC System**	**Total**
Balance at December 31, 2019	$ -	$ -	$ -	$ -
Additions	163,230	481,472	-	644,702
Balance at September 30, 2020	$ 163,230	$ 481,472	$ -	$ 644,702
Additions	-	83,228	2,906,219	2,989,447
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**

(Expressed in Canadian dollars, except share amounts)

As the technology assets have not yet reached commercialization, no amortization charge was recorded for the year ended September 30, 2021 (2020 - $nil). At September 30 2021, management concluded there was no impairment on the Phantom System and LEC System (2020 - $nil). Management anticipates the estimated useful life of five years for both technology assets.

For the additions during the year ended September 30, 2021, and the nine months ended September 30, 2020, refer to Note 4.

10. Accounts payable and accrued liabilities

The following table presents the accounts payable and accrued liabilities for KWESST:

	September 30, 2021	September 30, 2020
Trade payable	**$ 620,041**	$ 493,027
Accrued liabilities	**384,239**	188,265
Salary and vacation payable	**122,230**	65,722
Payroll taxes payable	**692**	67,229
Other	**-**	4,031
Total	**$ 1,127,202**	$ 818,274

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

Key management personnel compensation comprised the following:

	Year ended September 30, 2021	Nine months ended September 30, 2020
Wages and benefits	**$ 427,252**	$ 165,769
Consulting fees	**180,000**	145,000
Directors compensation	**85,000**	-
Share-based compensation	**988,716**	24,959
Total	**$ 1,680,968**	$ 335,728

The consulting fees relate to compensation paid to KWESST's Executive Chairman (via his private corporation, DEFSEC Corp) and for the prior periods the consulting fees also include the former Chief Financial Officer.

(Expressed in Canadian dollars, except share amounts)

Related party loans

The following table summarizes the related party loans.

	CEO loan (1)	Employee loan	Loans from investors	Total
Balance, December 31, 2019	$ 229,918	$ 59,910	$ -	$ 289,828
Accrued interest	7,174	1,274	-	8,448
Repayment of loans	(30,000)	(50,000)	-	(80,000)
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	**$ -**	**$ -**	**$ -**	**$ -**

(1) Includes a loan held by 2573685 Ontario Inc., the parent company at the time (co-owned by the CEO and his spouse).

The CEO and employee loans accrued interest at TD Bank prime plus 1.55% and 5%, respectively. As noted in the above table, all related party loans have been repaid during the year ended September 30, 2021.

Other related party transactions:

- In April 2021, two directors and the CFO of the Company participated in the brokered private placement (see Note 16(a)); collectively, they purchased 72,000 Units for a total consideration of $90,000. This transaction was recorded at fair value.

- In November 2019, KWESST hired SageGuild LLC to assist the Company in promoting its product offerings in the United States. In January 2021, the Acting CEO and sole shareholder of SageGuild LLC agreed to serve as director of KWESST U.S. Inc. and as a result SageGuild LLC became a related party to KWESST. The total cash and share-based remuneration amounted to $296,318 and $42,991 for business development costs from January 1, 2021, to September 30, 2021, respectively. Except for the cash consideration recorded at the exchange amount, the share-based compensation was recorded at fair value (see Note 16(c)).

- Two directors of KWESST were investors in the 2019 convertible notes, in which KWESST incurred finance costs of $6,585 on these convertible notes for the nine months ended September 30, 2020. These were converted to common shares of KWESST in September 2020, based on the conversion rate as defined in the convertible note agreement.

- The lease for a 3-D printer was with a private company owned by KWESST's President and CEO and his spouse (see Note 13). This transaction was recorded at the exchange amount.

At September 30, 2021 and September 30, 2020, there was no outstanding amount in accounts payable and accrued liabilities due to officers and directors of KWESST.

(Expressed in Canadian dollars, except share amounts)

12. Borrowings

	CEBA Term Loan	Unsecured Loan	Total
Balance, December 31, 2019	$ -	$ -	$ -
Additional borrowings	40,000	-	40,000
Gain on government grant	(9,096)	-	(9,096)
Accrued interest	1,369	-	1,369
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**
Current	$ -	$ -	$ -
Non-current	53,251	-	53,251
Total	**$ 53,251**	**$ -**	**$ 53,251**

CEBA Term Loan

In December 2020, the Canadian Federal Government amended the CEBA Term Loan program to increase the loan amount by $20,000 to $60,000. KWESST borrowed $40,000 in the nine-month period ended September 30, 2020, and an additional $20,000 during the current year. Additionally, effective January 1, 2021, the outstanding balance of the CEBA Term Loan was automatically converted to a 2-year interest free term loan. Accordingly, KWESST has presented this loan as non-current borrowings at September 30, 2021. The CEBA Term loan was initially recorded at fair value, discounted based on KWESST's estimated incremental borrowing rate of 10%. This resulted in recording a gain on government grant of $3,514 for the year ended September 30, 2021 (2020 - $9,096).
The CEBA Term Loan may be repaid at any time without notice or the payment of any penalty. If the CEBA Term Loan is repaid on or before December 31, 2022, $20,000 shall be forgiven. If on December 31, 2022, KWESST exercises the option for a 3-year term extension, a 5% annual interest will be applied on any balance remaining during the extension period.

KWESST has not recorded the potential forgivable amount at September 30, 2021 and 2020.

RBC Credit Facility

KWESST maintains corporate credit cards for its key employees and a foreign exchange line of credit with Royal Bank of Canada ("RBC"). To provide security, KWESST 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.

Unsecured Loan

On February 24, 2021, KWESST 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, KWESST repaid the loan, including accrued interest, for a total of $310,527.

(Expressed in Canadian dollars, except share amounts)

13. Lease obligations

During the nine months ended September 30, 2020, KWESST terminated an office lease and entered into a long-term office lease contract. The office lease includes the right to renew for an additional five years following its expiry on April 30, 2026. Management has not included the renewal option because it was deemed too uncertain whether KWESST would renew at this time.

Under the new office lease, KWESST benefits 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.

When measuring the lease obligation, the Company discounted the remaining lease payments using the incremental estimated borrowing rate of Company of 10% per annum at the time of closing the new lease agreement.

The following table presents lease obligations for KWESST:

	Offices	Printer	Total	Current Portion	Non-current portion
Balance, December 31, 2019	$ 195,463	$ 7,223	$ 202,686	$ 85,468	$ 117,218
Addition	347,640	-	347,640	-	-
Termination	(157,315)	-	(157,315)	-	-
Lease payments (including interest)	(62,816)	(7,620)	(70,436)	-	-
Interest expense	29,065	397	29,462	-	-
Balance, September 30, 2020 (as adjusted)	$ 352,037	$ -	$ 352,037	$ 44,128	$ 307,909
Lease payments (including interest)	(78,000)	-	(78,000)	-	-
Interest expense	33,872	-	33,872	-	-
Balance at September 30, 2021	**$ 307,909**	**$ -**	**$ 307,909**	**$ 32,288**	**$ 275,621**

Refer to Note 8 regarding the correction of an error in the application of IFRS 16.

The termination of the former lease resulted in the de-recognition of the lease obligation and related unamortized book value of the right-of-use asset, resulting in a gain of $17,527. This was included in the net finance costs for the nine months ended September 30, 2020 (see Note 20).

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

	September 30, 2021	September 30, 2020
Less than one year	**$ 62,400**	$ 78,000
One to five years	**327,600**	390,000
Total	**$ 390,000**	$ 468,000

(Expressed in Canadian dollars, except share amounts)

14. Contract Liabilities

The following table presents the changes in contract liabilities:

	September 30, 2021	September 30, 2020
Balance, beginning of period	**$ 7,053**	$ -
Amounts invoiced and revenue deferred	**-**	7,053
Recognition of deferred revenue included in the balance at the beginning of period	**(7,053)**	-
Balance, end of period	**$ -**	$ 7,053

15. Convertible notes

The following table presents the changes in KWESST's convertible notes:

	September 30, 2021	September 30, 2020
Balance, beginning of period	**$ -**	$ 210,819
Accrued interest	**-**	16,769
Accretion expense	**-**	28,130
Converted into common shares (note 16)	**-**	(255,718)
Balance, end of period	**$ -**	$ -

2020 Activities

As disclosed in Note 4(b), a Liquidity Event occurred which resulted in the conversion of the $255,718 outstanding convertible note, including accrued interest up to Liquidity Event, into 456,639 common shares (see Note 16).

16. Share capital and Contributed Surplus

a) Share capital

Authorized

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

(Expressed in Canadian dollars, except share amounts)

Issued Common Shares

	September 30, 2021		September 30, 2020	
	Number	**Amount**	**Number**	**Amount**
Balance, beginning of period	41,266,176	$ 9,374,563	26,879,686	$ 2,284,353
Issued in brokered private placement	3,576,057	$ 3,611,818	4,409,553	$ 3,087,138
Issued for exercise of stock options	1,273,671	$ 1,292,015	122,000	$ 78,080
Issued for asset acquisition	1,000,000	$ 1,290,000	697,000	$ 167,280
Issued in private placement	750,000	$ 1,110,000	3,486,750	$ 1,480,875
Issued for exercise of warrants	726,575	$ 815,307	-	$ -
Issued for exercise of broker compensation options	172,108	$ 347,680	-	$ -
Issued for amended license	100,000	$ 137,000	-	$ -
Issued for debt settlements	91,356	$ 63,866	-	$ -
Issued for share units	9,688	$ 12,498	-	$ -
Issued for conversion of 15% 2020 converted notes	-	$ -	3,210,050	$ 1,328,163
Issued for performance bonus	-	$ -	1,045,000	$ 731,500
Shares from Foremost's QT (Note 4(b))	-	$ -	898,498	$ 628,949
Issued for conversion of 10% 2019 converted notes	-	$ -	456,639	$ 255,718
Issued for consulting services	-	$ -	61,000	$ 32,393
Less: share offering costs for the year	-	$ (839,679)	-	$ (699,886)
Balance, end of period	**48,965,631**	**$ 17,215,068**	**41,266,176**	**$ 9,374,563**

2021 Activities

Brokered Private Placement

In April 2021, KWESST closed its previously announced over-subscribed brokered private placement, resulting in the issuance of 3,576,057 units ("Units") of KWESST, at a price of $1.25 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, KWESST sold a total of 3,576,057 units at a price of $1.25 per Unit. Each Unit is comprised of one common share of the Company and one common share purchase warrant ("April 2021 Warrant"). Each April 2021 Warrant is exercisable to acquire one common share at a price of $1.75 each 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 $3.00 for a period of 10 consecutive trading days, as evidenced by the price at the close of market, KWESST shall 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. Directors and officers of KWESST purchased 72,000 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 $1.25 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. As a result, $1.01 of the $1.25 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 LEC System technology resulting in the issuance of 1 million 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, KWESST closed a non-brokered private placement, resulting in the issuance of 750,000 units ("September Units") of KWESST, at a price of $2.00 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 one Warrant Share exercisable at a price of $2.35 each 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 $4.60 for a period of 3 consecutive trading days, as evidenced by the price at the close of market, KWESST 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.

KWESST 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 one 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 $2.00 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. As a result, $1.48 of the $2.00 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, KWESST issued 100,000 common shares for the exclusivity with AerialX as disclosed in Note 20.

Debt for Equity Settlement

In December 2020, KWESST settled the following liabilities with its common shares:

- $47,000 of legal fees for 67,142 common shares; and
- $16,866 of online advertising services for 24,214 common shares.

2020 Activities

Brokered Private Placements

In September 2020, KWESST closed a brokered private placement led by PI Financial Corp., resulting in the issuance of 4,409,553, at $0.70 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 $0.45, resulting in the issuance 600,839 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 2,477,851 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 131,360 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 2,625,000 common shares of KWESST, at $0.40 each, for aggregate gross proceeds of $1,050,000.

In March 2020, KWESST closed a non-brokered private placement, resulting in the issuance of 845,750 common shares of KWESST, at $0.50 each, for aggregate gross proceeds of $422,875.

In June 2020, KWESST closed a non-brokered private placement, resulting in the issuance of 16,000 common shares of KWESST, at $0.50 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 45,000 common shares. Additionally, KWESST awarded 500,000 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 898,498 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 (b)) all the 2019 Convertible Notes and accrued interest were automatically converted to 456,639 common shares of KWESST.

(Expressed in Canadian dollars, except share amounts)

Asset Acquisition

As disclosed in Note 4(c), KWESST issued 697,000 common shares to acquire the Phantom™ System technology.

b) Warrants

The following reflects the warrant activities for KWESST:

	September 30, 2021			September 30, 2020		
	Number of warrants		**Weighted average exercise price**	Number of warrants		Weighted average exercise price
Outstanding, beginning of period	**9,585,050**	**$**	**0.24**	8,500,000	$	0.20
Issued during the period	**5,043,165**	**$**	**1.73**	1,085,050	$	0.54
Exercised during the period	**(726,575)**	**$**	**1.05**	-	$	-
Outstanding, end of period	**13,901,640**	**$**	**0.74**	9,585,050	$	0.24
Exercisable, end of period	**12,901,640**	**$**	**0.75**	8,835,050	$	0.22

The following table provides additional information on the total outstanding warrants at September 30, 2021:

	Number outstanding		**Fair value (1)**	**Expiry Date**
Founders' warrants:				
Exercise price of $0.20	6,500,000	$	1,192	January 1, 2024
Exercise price of $0.20	2,000,000	$	19,858	June 14, 2024
GhostStep's warrants (Note 4(c)):				
Exercise price of $0.50	500,000	$	120,000	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 (Note 4(a)):				
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 $0.45	84,622	$	17,162	May 8, 2022
Exercise price of $0.70	69,862	$	14,259	July 9, 2022
Exercise price of $1.75	137,499	$	33,000	April 29, 2023
Exercise price of $2.00	45,000	$	32,400	September 16, 2023
	13,901,640	**$**	**1,848,389**	

(1) Fair value is calculated based on the grant date fair value and number outstanding at September 30, 2021. It does not represent the fair value at September 30, 2021.

(Expressed in Canadian dollars, except share amounts)

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**
Stock price	$	1.01	$	2.14	$	2.14	$	1.29
Volatility		80%		80%		80%		80%
Dividend Yield		Nil		Nil		Nil		Nil
Risk-free interest rate		0.31%		0.26%		0.26%		0.48%
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		3
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
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 the 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) 230,734 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 $1.25 for a period of two years after the closing of the Offering. Each Compensation Option Unit is comprised of one Common Share and one Common Share purchase warrant (a "Compensation Option Warrant"). Each Compensation Option Warrant is exercisable to acquire one Common Share (a "Compensation Option Warrant Share") at a price of $1.75 per Compensation Option Warrant Share for a period of 24 months from the closing of the Offering.

(Expressed in Canadian dollars, except share amounts)

Based on the structure of the Compensation Option, management estimated its fair value using the Monte Carlo method. Management estimated a fair value of $1.10 per Compensation Option. The following were key inputs used in the Monte Carlo simulation: estimated life of 2 years, underlying stock price of $1.29, exercise price of Compensation Option of $1.25, exercise price of Compensation Option Warrant of $1.75, estimated volatility of 80%, risk free rate of 0.31%, and discount for lack of marketability of 0%.

Accordingly, KWESST 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 172,118 Compensation Option Units for total gross proceeds of $215,148. At September 30, 2021, the total outstanding Compensation Option Units was 58,616.

Share-based compensation

On March 31, 2021, KWESST shareholders approved the Company's Long-Term Incentive Plan (the "LTIP"), replacing the former Stock Option Plan, 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. The TSX-V accepted the filing of the LTIP on April 9, 2021.

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 4,226,737 shares. The LTIP is subject to annual shareholder approval at the Annual General and Special Meeting.

(i) Stock Options

At September 30, 2021, there were 729,049 stock options available for grant under KWESST's LTIP.

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

	Number of options	Weighted average exercise price	
Outstanding at December 31, 2019	-	$	-
Granted	2,055,000	$	0.65
Options from the Foremost QT (see Note 4(b))	85,714	$	0.47
Exercised	(122,000)	$	0.50
Outstanding at September 30, 2020	2,018,714	$	0.65
Granted	3,709,125	$	1.49
Exercised	(1,273,573)	$	0.72
Cancelled	(286,750)	$	0.69
Outstanding at September 30, 2021	**4,167,516**	**$**	**1.37**
Options exercisable at September 30, 2021	**1,844,328**	**$**	**1.25**

(Expressed in Canadian dollars, except share amounts)

During the year ended September 30, 2021, KWESST granted 3,709,125 (2020 – 2,055,000) options to directors, officers, employees and consultants at a weighted average exercise price of $1.49 (2020 – 0.65). At September 30, 2021, the weighted average remaining vesting period was 1.82 years (2020 – 0.87 years).

For the options granted during the year ended September 30, 2021, and the nine months ended September 30, 2020, the per share weighted-average fair value of stock options was $0.72 and $0.23, respectively, using the Black-Scholes option model with the following weighted-average assumptions:

	2021	2020
Volatility	**76.46%**	67.71%
Dividend yield	**Nil**	Nil
Risk-free interest rate	**0.35%**	0.65%
Expected life (years)	**2.26**	3.38
Weighted-average fair value per option	**$ 0.72**	**$ 0.23**

For the year ended September 30, 2021, KWESST recorded stock-based compensation expenses of $1,854,240 (2020 - $283,084) related to the vesting of options.

The following table summarizes information about stock options outstanding at September 30, 2021:

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**
$0.25 to $0.70	640,578	3.56	$	0.67	523,703	3.59	$	0.67
$0.71 to $1.15	1,087,813	4.21	$	0.93	500,000	4.16	$	0.92
$1.16 to $1.60	646,875	4.63	$	1.29	125,000	4.55	$	1.33
$1.61 to $2.05	1,442,250	4.33	$	1.83	508,125	3.97	$	1.76
$2.06 to $2.50	350,000	4.48	$	2.23	187,500	4.35	$	2.28
	4,167,516	**4.24**	**$**	**1.37**	**1,844,328**	**3.99**	**$**	**1.25**

Amendment to stock option grants

During the year ended September 30, 2021, the Board approved the acceleration of vesting for 385,500 options and the cancellation of 250,000 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, 2021, there were 2,727,977 Share Units available for grant under KWESST’s LTIP.

(Expressed in Canadian dollars, except share amounts)

During the year ended September 30, 2021, the Board granted the following Share Units:

	RSUs	PSUs	SARs	Total
Outstanding at September 30, 2020	-	-	-	-
Granted	1,148,760	200,000	150,000	1,498,760
Vested and converted	(9,688)	-	-	(9,688)
Outstanding at September 30, 2021	**1,139,072**	**200,000**	**150,000**	**1,489,072**

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, 2021, KWESST granted 398,760 to directors and officers and 750,000 to consultants. The weighted-average grant date fair value of the RSUs granted in 2021 was $1.51 per unit (2020 – $nil). The weighted average vesting period for the outstanding RSUs is 0.69 years. KWESST recorded share-based compensation of $204,386 (2020 - $nil) related to the RSUs.

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, 2021, KWESST granted 50,000 PSUs to an employee and 150,000 PSUs to a consultant. The weighted-average grant date fair value of the PSUs granted in 2021 was $1.50 per unit (2020 – $nil). The weighted average vesting period for the outstanding PSUs is 0.40 years. KWESST recorded share-based compensation of $171,924 (2020 - $nil) related to the PSUs.

SARs:

Each SAR entitles the holder to receive cash or common share at the discretion of the Company 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 KWESST intends to always settle in common shares, KWESST accounts for SARs as equity-settled awards.

During the year ended September 30, 2021, KWESST granted 150,000 SARs to a consultant at an exercise price of $1.65 each. KWESST recorded share-based compensation of $30,657 (2020 - $nil) related to the SARs. The SARs will expire on July 20, 2022.

(iii) Share-based Compensation

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

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

(Expressed in Canadian dollars, except share amounts)

17. 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, 2021	Nine months ended September 30, 2020
Issued common shares, beginning of period	41,266,176	26,879,686
Effect of shares issued from:		
Private placements	1,526,692	3,196,518
Exercise of options	638,292	31,282
Asset acquisitions	421,918	89,055
Exercise of warrants	306,776	-
Debt settlements	72,664	-
Amended license agreement	43,836	-
Exercise of broker options	11,979	-
Conversion of stock units	2,203	-
Conversion of convertible notes, including interest	-	498,810
Services rendered	-	96,081
Qualifying transaction	-	52,697
Weighted average number of basic common shares	**44,290,536**	**30,844,129**
Dilutive securities:		
Stock options	-	-
Warrants	-	-
Weighted average number of dilutive common shares	**44,290,536**	**30,844,129**

At September 30, 2021 and 2020, all the stock options and warrants were anti-dilutive because of KWESST's net loss for both periods.

18. 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.

(Expressed in Canadian dollars, except share amounts)

	Year ended September 30, 2021	Nine months ended September 30, 2020
Major products / service lines		
Digitization systems	**$ 1,255,982**	$ 835,097
Other	**19,822**	26,820
	$ 1,275,804	$ 861,917
Primary geographical markets		
United States	**$ 1,238,063**	$ 835,097
Canada	**37,741**	26,820
	$ 1,275,804	$ 861,917
Timing of revenue recognition		
Products and services transferred over time	**$ 1,238,063**	$ 835,097
Products transferred at a point in time	**37,741**	26,820
	$ 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, 2021, KWESST's contracted not yet recognized revenue was $16,545 (2020 - $233,193), of which 100% of this amount is expected to be recognized over the next 12 months.

For the year ended September 30, 2021, one customer accounted for the revenue based in the United States (2020 – two customers).

19. **Expenses by nature**

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

	Year ended September 30, 2021	Nine months ended September 30, 2020 (Adjusted - see Note 8)
Employee benefits	**$ 4,746,316**	$ 1,161,071
Advertising and promotion	**1,914,630**	220,946
Consulting fees	**1,138,782**	620,295
R&D consulting and material costs, net	**482,348**	100,483
Professional fees	**722,457**	190,398
Other expenses	**497,120**	106,007
Royalty and license costs	**287,000**	-
Travel and conferences	**246,418**	112,360
Depreciation and amortization	**196,156**	103,396
Merger and acquisition costs	**22,255**	1,561,860
Total expenses	**10,253,482**	4,176,816
Allocation to cost of sales:		
Employee benefits	**(574,018)**	(71,105)
Total operating expenses	**9,679,464**	$ 4,105,711

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

21. Income taxes

a) Reconciliation of effective income tax rate

KWESST's 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:

	Year ended September 30, 2021	Nine months ended September 30, 2020
		(Adjusted - see Note 8)
Loss before income taxes	$ (9,315,372)	(3,536,778)
Expected statutory tax rate	26.5%	26.5%
Expected tax recovery resulting from loss	(2,468,574)	(937,246)
Increase (reduction) in income taxes resulting from:		
Non-deductible expenses	654,956	275,273
Foreign operations subject to different tax rates	3,593	
Unrecognized temporary differences	1,826,279	661,973
Prior year differences	(16,254)	-
	$ -	$ -

(Expressed in Canadian dollars, except share amounts)

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, 2021	Nine months ended September 30, 2020
		(Adjusted - see Note 8)
R&D expenses	**$ 2,369,145**	$ 944,909
Less:		
Investment tax credits	**(231,007)**	(127,325)
R&D expenses, net	**2,138,138**	817,584

b) Deferred tax balances

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

	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)
	-	-	-	-

c) 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, 2021 and September 30, 2020, due to the uncertainty involved in determining whether these deferred tax assets will be realized upon expiration due to KWESST's limited history and operating losses since its inception.

(Expressed in Canadian dollars, except share amounts)

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

	Balance at September 30, 2021	Balance at September 30, 2020	Balance at December 31, 2019
Net operating loss carryforwards	9,429,436	4,279,494	2,111,531
Share issuance costs	1,810,927	1,496,239	17,281
Intangibles and development costs	780,607	-	-
Scientific research and development expenditures	1,789,571	218,235	170,940
Other	104,793	46,891	22,106
	13,915,334	6,040,859	2,321,858

d) Available net operating losses

At September 30, 2021, KWESST has the following net operating losses in Canada available to reduce future year's taxable income which expire as follows:

Year of Expiry	**Amount**
2036	**$ 512,163**
2037	**744,022**
2038	**1,174,797**
2039	**1,732,039**
2040 and thereafter	**5,266,415**
	$ 9,429,436

e) 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	**329,283**
	$ 349,386

22. Financial instruments

Fair value of financial instruments

The fair values of KWESST's 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, 2021, the fair value for accrued royalties liability approximates its carrying value as the 13.7% discount rate used at inception continues to reflect a reasonable market discount rate at September 30, 2021. Using the same market discount rate, the fair value of the borrowings was $49,825 at September 30, 2021.

In connection with the issuance of the 2018 debentures and 2019 convertible notes, management determined that the conversion feature was a financial derivative liability, requiring fair value remeasurement at each reporting period. Management used the Black-Scholes option model to remeasure the estimated fair value of the financial derivative liabilities (Level 2).

The following table shows the movement of the financial derivative liabilities in 2020:

		Total
Balance at December 31, 2019		29,463
Adjustment upon convertible notes converted to common sha		(29,463)
Balance at September 30, 2020	**$**	**-**

Financial risk management

KWESST is exposed to a number of financial risks arising through the normal course of business as well as through its financial instruments. KWESST's overall business strategies, tolerance of risk and general risk management philosophy are determined by the 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, 2021, KWESST's indebtedness was interest free. Accordingly, KWESST has no interest rate risk.

(b) Foreign currency risk

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

For the year ended September 30, 2021 and nine months ended September 30 2020, KWESST's revenue was substantially denominated in US dollar driven by contracts with U.S. prime contractors in the defense sector. KWESST also procures certain raw materials denominated in US dollar for product development. Accordingly, KWESST is exposed to the US dollar currency. Where a natural hedge cannot be achieved, a significant change in the US dollar currency could have a significant effect on KWESST's financial performance, financial position and cash flows. Currently, KWESST does not use derivative instruments to hedge its US dollar exposure.

(Expressed in Canadian dollars, except share amounts)

At September 30, 2021, KWESST had the following net US dollar exposure:

		Total USD
Net liabilities in U.S. subsidiary	$	6,221
US denominated:		
Assets	$	268,178
Liabilities		(74,720)
Net US dollar exposure	**$**	**187,237**
Impact to profit or loss if 5% movement in the US dollar	**$**	**9,362**

During the year ended September 30, 2021, KWESST recorded foreign exchange loss of $3,742 (2020 - $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. KWESST's credit risk exposure is limited to cash, and trade and other receivables. Refer to Note 5 for the breakdown of KWESST's trade and other receivables. KWESST enters into contracts with large, financially sound US general contractors, which mitigates the credit risk. At September 30, 2021, KWESST had no outstanding trade receivable. The remaining receivable is due from the Canadian Federal and Provincial Government for sales tax recoverable and investment tax credits.

(d) Liquidity risk

Liquidity risk is the risk that KWESST will be unable to meet its financial obligations as they become due. KWESST's objective is to ensure that it has sufficient cash to meet its 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 KWESST's cash flows due to its early stage in operations and the need for additional capital to fund its business strategies (see Note 2(a)).

At September 30, 2021, our contractual obligations were as follows:

Payment due:	**Total**	**Within 1 Year**	**1 to 3 years**	**3 to 5 years**
Minimum royalty commitments	**$ 2,500,000**	$ -	$ 150,000	$ 2,350,000
Accounts payable and accrued liabilities	**1,127,202**	1,127,202	-	-
Lease obligations	**390,000**	62,400	187,200	140,400
Other commitments	**101,928**	101,928	-	-
Borrowings	**60,000**	-	60,000	-
Total contractual obligations	**$ 4,179,130**	**$ 1,291,530**	**$ 397,200**	**$ 2,490,400**

At September 30, 2021, KWESST had $2.7 million in cash and $2.9 million in working capital (current assets less current liabilities).

(Expressed in Canadian dollars, except share amounts)

23. Supplemental cash flow information

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

	Year ended September 30, 2021	Nine months ended September 30, 2020
Trade and other receivables	$ (218,334)	$ (257,588)
Inventories	17,555	-
Prepaid expenses and other	(106,205)	(387,762)
Accounts payable and accrued liabilities	(828,698)	393,202
Contract liabilities	(7,053)	7,053
Deposits	150,000	-
Accrued royalties liability	1,191,219	-
	$ 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 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 (Note 4(c));
- $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(a)),
- $137,000 fair value of common shares issued for the amended and restated license agreement with AerialX (Note 26(a));
- $169,832 share offering costs relating to the Broker Compensation Options (Note 16(a)); and
- $3,828 non-cash consideration for computer equipment acquired.

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(b)); and
- $17,531 fair value of options exercised and transferred to KWESST's common shares.

24. Segmented information

KWESST's Executive Chairman has been identified as the chief operating decision maker. The Executive Chairman evaluates the performance of KWESST and allocates resources based on the information provided by its internal management system at a consolidated level. KWESST has determined that it has only one operating segment.

(Expressed in Canadian dollars, except share amounts)

At September 30, 2021, September 30, 2020, all of KWESST's property and equipment are located in Canada, including the right-of-use assets.

25. Capital management

KWESST's objective in managing its capital is to safeguard its ability to continue as a going concern and to sustain future development of the business. The Company's 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 its growth strategy. The Board of Directors is responsible for overseeing this process. From time to time, KWESST could issue new common shares or debt to maintain or adjust its capital structure. KWESST is not subject to any externally imposed capital requirements.

KWESST's capital is composed of the following:

	September 30, 2021	September 30, 2020
Debt:		
Lease obligations	**$ 307,909**	$ 352,037
Related party loans	**-**	218,276
Borrowings	**53,251**	32,273
Equity:		
Share capital	**17,215,068**	9,374,563
Warrants	**1,848,389**	277,170
Contributed surplus	**2,458,211**	306,708
Accumulated other comprehensive loss	**(8,991)**	-
Accumulated deficit	**(15,388,949)**	(6,073,577)
Total capital	**$ 6,484,888**	$ 4,487,450

26. Commitments and contingencies

a) AerialX Drone Solutions ("AerialX")

On April 5, 2021, KWESST 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, KWESST has issued 100,000 common shares to AerialX ("Exclusive License Shares"). Based on KWESST's closing stock price of $1.37 on April 23, 2021 (TSX-V approval date), the fair value for these shares was $137,000. KWESST recorded the $137,000 fair value as a license cost for the year ended September 30, 2021, with an equal offset to KWESST's share capital.

In addition to the Exclusive License Shares, KWESST also agreed to issue an additional 100,000 common shares upon AerialX achieving the technical milestones. For the year ended September 30, 2021, Aerial X has not delivered on the technical milestones and therefore no recognition was made.

Additionally, KWESST also agreed to issue up to 300,000 common shares subject to achieving the following performance milestones:

(Expressed in Canadian dollars, except share amounts)

# of Common Shares	Milestones
75,000	$3 million in sales
100,000	$9 million in sales
125,000	$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 KWESST.

Under this agreement, KWESST 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 KWESST made a payment of $150,000 as an advance for future royalty payments (the "Advance"). This Advance was recorded as a non-current deposit in the audited consolidated statements of financial position at December 31, 2019 and September 30, 2020. During the year ended September 30, 2021, management performed a recoverability review of all KWESST's financial assets, including this Advance. Management made the recoverability assessment on the Advance based on anticipated future sales of the licensed technology. While KWESST continues to work with AerialX on this project, management has concluded the timing and volume of future sales of the licensed drone was uncertain at this stage given AerialX has not yet met the technological milestones. Accordingly, KWESST took a charge to net loss. This charge is included in general and administrative expenses in the condensed consolidated interim statements of net loss and comprehensive loss.

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

b) STRYK Group USA, LLC ("STRYK")

On September 24, 2021, KWESST entered into a services agreement with STRYK to obtain branding and website management services over a period of four months from the date upon which the agreement was signed. These services are focused on strategic promotional activities related to the LEC System. Under the agreement, KWESST has committed to future minimum payments of $101,928, due within the next fiscal year.

27. Depreciation and Amortization

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

	2021	2020
General and administrative	$ 95,310	$ 89,307
Selling and marketing	16,443	-
Research and development	29,237	14,090
Total depreciation and amortization	**$ 140,990**	**$ 103,397**