

Condensed Consolidated Interim Financial Statements of
KWESST MICRO SYSTEMS INC.

Three and nine months ended June 30, 2021, and 2020

(Unaudited – in Canadian dollars)

KWESST MICRO SYSTEMS INC.

Table of Contents for the three and nine months ended June 30, 2021

	Page
FINANCIAL STATEMENTS	
Condensed Consolidated Interim Statements of Financial Position	3
Condensed Consolidated Interim Statements of Net Loss and Comprehensive Loss	4
Condensed Consolidated Interim Statements of Changes in Shareholders' Equity (Deficit)	5
Condensed Consolidated Interim Statements of Cash Flows	6
Notes to the Condensed Consolidated Interim Financial Statements	7-31

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

<i>In Canadian dollars</i>	<i>Notes</i>	June 30, 2021	September 30, 2020
			(Adjusted - see Note 8)
ASSETS			
Cash		\$ 2,432,126	\$ 3,073,760
Restricted short-term investment	12	30,000	-
Trade and other receivables	5	457,337	480,917
Inventories	6	549,928	-
Prepaid expenses and other		404,858	441,837
Current assets		3,874,249	3,996,514
Property and equipment	7	252,910	174,644
Right-of-use assets	8	280,735	327,576
Intangible assets	4, 9	3,287,204	644,702
Deposits		20,841	19,341
Other assets	20	-	150,000
Non-current assets		3,841,690	1,316,263
Total Assets		\$ 7,715,939	\$ 5,312,777
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Accounts payable and accrued liabilities	10	\$ 996,555	\$ 818,274
Related party loans	11	-	218,276
Borrowings	12	-	32,273
Lease obligations	13	31,494	44,128
Contract liabilities		-	7,053
Current liabilities		1,028,049	1,120,004
Lease obligations	13	291,859	307,909
Borrowings	12	51,987	-
Accrued royalties liability	4 (a)	966,299	-
Non-current liabilities		1,310,145	307,909
Total Liabilities		2,338,194	1,427,913
Shareholders' Equity	14		
Share capital		14,702,547	9,374,563
Warrants		1,447,833	277,170
Contributed surplus		1,732,247	306,708
Accumulated deficit		(12,504,882)	(6,073,577)
Total Shareholders' equity		5,377,745	3,884,864
Total Liabilities and Shareholders' Equity		\$ 7,715,939	\$ 5,312,777

See Note 2(a) Going Concern

See Note 20 Commitments and contingencies

See accompanying notes to condensed consolidated interim financial statements.

On behalf of the Board of Directors:

(signed) John McCoach, Director

(signed) David Luxton, Director

KWESST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Net Loss and Comprehensive Loss
For the three and nine months ended June 30, 2021 and 2020

<i>In Canadian dollars</i>	<i>Notes</i>	Three Months Ended June 30 2021	Three Months Ended June 30 2020	Nine Months Ended June 30 2021	Nine Months Ended June 30 2020
			(Adjusted - see Note 8)		
Revenue	16	\$ 521,724	\$ 600,474	\$ 1,115,757	\$ 653,174
Cost of sales		(315,273)	(143,536)	(718,309)	(159,527)
Gross profit		206,451	456,938	397,448	493,647
Operating expenses					
Advertising and promotion		602,708	78,651	1,427,035	102,666
Stock-based compensation	14	520,423	125,296	1,398,881	145,962
Personnel costs		554,134	327,067	1,202,607	846,664
Professional fees		110,791	62,885	506,254	183,178
Business development	11	200,011	127,451	424,371	212,996
R&D consulting and material costs, net	21	173,107	26,805	423,892	207,773
Consulting fees	11	160,396	99,022	416,720	328,135
Royalty and license costs		287,000	-	287,000	-
General and administrative expenses		86,569	29,454	167,089	37,838
Travel and conferences		14,588	25,998	138,958	138,742
Insurance		44,982	9,161	104,617	25,458
Transfer agent and TSX-V fees		28,455	-	90,168	-
Depreciation and amortization	7, 8	13,439	53,925	88,484	112,711
Impairment of intangible assets	9	-	-	55,376	-
Merger and acquisition costs		1,268	81,907	22,255	81,907
Total operating expenses		2,797,871	1,047,622	6,753,707	2,424,030
Operating loss		(2,591,420)	(590,684)	(6,356,259)	(1,930,383)
Other income (expenses)					
Fair value adjustments on derivatives	18	-	(89,489)	-	(64,948)
Gain on government grant	12	-	-	3,514	-
Net finance costs	17	(27,780)	(81,546)	(64,371)	(158,687)
Foreign exchange loss		(9,025)	(14,549)	(14,189)	(9,727)
Total other expenses		(36,805)	(185,584)	(75,046)	(233,362)
Net loss and comprehensive loss		\$ (2,628,225)	\$ (776,268)	\$ (6,431,305)	\$ (2,163,745)
Net Loss per share					
Basic and diluted		\$ (0.06)	\$ (0.03)	\$ (0.15)	\$ (0.10)
Weighted average number of shares outstanding					
Basic and diluted	15	46,016,645	30,393,359	43,126,552	21,860,441

See accompanying notes to condensed consolidated interim financial statements.

KWEST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Changes in Shareholders' Equity (Deficit)
For the nine months ended June 30, 2021 and 2020

	Common Shares				Contributed Surplus				Total Shareholders' Equity (Deficit)
	Number Issued	Share Capital	Warrants	Compensation Options	Options	RSUs	Deficit	Shareholders' Equity (Deficit)	
Balance, September 30, 2019	18,700,200	\$ 648,508	\$ 21,050	\$ -	\$ -	\$ -	\$ (1,838,011)	\$ (1,168,453)	
Shares issued for cash	8,561,750	2,495,823	-	-	-	-	-	2,495,823	
Shares issued for converted debt and accrued interest	3,104,486	620,897	-	-	-	-	-	620,897	
Shares for consulting services	61,000	32,393	-	-	-	-	-	32,393	
Shares and warrants issued on asset acquisition	140,000	33,600	-	-	-	-	-	33,600	
Stock options exercised	61,000	39,040	-	-	(8,540)	-	-	30,500	
Share-based compensation	-	-	-	-	145,962	-	-	145,962	
Share offering costs	-	(130,707)	-	-	-	-	-	(130,707)	
Net loss	-	-	-	-	-	-	(2,163,745)	(2,163,745)	
Balance, June 30, 2020	30,628,436	\$ 3,739,554	\$ 21,050	\$ -	\$ 137,422	\$ -	\$ (4,001,756)	\$ (103,730)	
Balance, September 30, 2020 (adjusted - see Note 8)	41,266,176	\$ 9,374,563	\$ 277,170	\$ -	\$ 306,708	\$ -	\$ (6,073,577)	\$ 3,884,864	
Shares for debt settlements	91,356	63,949	-	-	-	-	-	63,949	
Warrants exercised	423,899	220,220	(102,991)	-	-	-	-	117,229	
Shares and warrants issued on asset acquisition	1,100,000	1,427,000	425,000	-	-	-	-	1,852,000	
Shares and warrants issued for cash	3,536,057	3,571,418	848,654	-	-	-	-	4,420,072	
Stock options exercised	854,884	736,419	-	-	(203,516)	-	-	532,903	
Share offering costs	-	(693,905)	-	233,057	-	-	-	(460,848)	
Share-based compensation	-	-	-	-	1,381,086	17,795	-	1,398,881	
Shares for vested RSUs	2,235	2,883	-	-	-	(2,883)	-	-	
Net loss	-	-	-	-	-	-	(6,431,305)	(6,431,305)	
Balance, June 30, 2021	47,274,607	\$ 14,702,547	\$ 1,447,833	\$ 233,057	\$ 1,484,278	\$ 14,912	\$ (12,504,882)	\$ 5,377,745	

See accompanying notes to condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Cash Flows
For the nine months ended June 30, 2021 and 2020

<i>In Canadian dollars</i>	Notes	Nine months ended June 30, 2021	Nine months ended June 30, 2020
OPERATING ACTIVITIES			
Net loss		\$ (6,431,305)	\$ (2,163,745)
<i>Items not affecting cash:</i>			
Depreciation and amortization	7, 8	88,484	112,711
Impairment of intangible assets	9	55,376	-
Share-based compensation	14	1,398,881	145,962
Shares for amended license	20	137,000	-
Fair value adjustments on derivative liabilities		-	64,948
Gain on government grant	12	(3,514)	-
Net finance costs		64,371	158,687
Changes in non-cash working capital items	19	1,610	26,737
Interest paid		(29,132)	(5,240)
Cash used in operating activities		(4,718,229)	(1,659,940)
INVESTING ACTIVITIES			
Acquisition of property and equipment	7	(119,909)	(105,767)
Investments in development projects	9	-	(124,739)
Deposit for advanced royalties		(150,000)	(150,000)
Purchase of restricted short-term investment	12	(30,000)	-
Acquisition of technology asset	4(b)	-	(134,912)
Cash flows used in investing activities		(299,909)	(515,418)
FINANCING ACTIVITIES			
Proceeds from the issuance of common shares	14	4,420,072	2,495,823
Proceeds from subscription deposits		-	105,000
Payments of share offering costs		(460,848)	(130,707)
Proceeds from convertible notes	14	-	1,049,860
Proceeds from borrowings	12	326,000	40,000
Repayment of borrowings		(306,000)	-
Repayments to related party loans	11	(218,276)	(80,000)
Repayments of lease obligations	13	(34,576)	(63,160)
Proceeds from exercise of warrants	14	117,229	-
Proceeds from exercise of stock options	14	532,903	30,500
Cash flows provided by financing activities		4,376,504	3,447,316
Net change in cash during the period		(641,634)	1,271,958
Cash, beginning of period		3,073,760	3,393
Cash, end of period		\$ 2,432,126	\$ 1,275,351

See accompanying notes to condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

1. Corporate information

KWESST 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, Ottawa, Ontario, Canada.

KWESST develops and commercializes next-generation tactical systems that meet the requirements of security forces and personal defense for overmatch capability against adversaries. 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 has also offices in the following foreign locations: Washington DC (United States), London (United Kingdom), and Abu Dhabi (United Arab Emirates).

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.

2. Basis of preparation

(a) *Going concern*

These unaudited condensed consolidated interim financial statements have been prepared assuming KWESST will continue as a going concern.

As an early-stage company, KWESST has incurred significant losses and negative operating cash flows from inception that have primarily been funded from financing activities. KWESST incurred approximately \$6.4 million net loss and negative operating cash flows of approximately \$4.7 million for the nine months period ended June 30, 2021 (2020 - \$2.2 million net loss and negative operating cash flows of \$1.7 million). At June 30, 2021, KWESST had a working capital of \$2.8 million (September 30, 2020 – working capital of \$2.9 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 risk and uncertainties affecting KWESST's operating including, but not limited to:

- The market acceptance and rate of commercialization of the KWESST's 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.

Failure to implement the Company's business plan could have a material adverse effect on the Company's financial condition and/or financial performance. Accordingly, there are material risks and uncertainties that may cast significant doubt about KWESST's ability to continue as a going concern.

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.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

These condensed consolidated interim financial statements do not include any adjustments or disclosures that would be required if assets are not realized and liabilities and commitments are not settled in the normal course of operations.

(b) Statement of compliance

These unaudited condensed consolidated interim financial statements have been prepared in accordance with IAS 34, Interim Financial Reporting, (“IAS 34”) as issued by the International Accounting Standards Board (“IASB”). They do not include all the information required for a complete set of financial statements prepared in accordance with International Financial Reporting Standards (“IFRS”) and should be read in conjunction with the annual consolidated financial statements of the Company for the period ended September 30, 2020. However, selected explanatory notes are included to explain events and transactions that are significant to an understanding of the changes in the Company’s financial position and performance since the last annual consolidated financial statements as at and for the period ended September 30, 2020.

These unaudited condensed consolidated interim financial statements were authorized for issue by the Board of Directors on August 24, 2021.

(c) Use of estimates and judgments

The preparation of the unaudited condensed consolidated interim 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.

The continuing uncertainty around the outbreak of the novel coronavirus (“COVID-19”) pandemic required the use of judgments and estimates in the preparation of the condensed consolidated interim financial statements for the three and nine months ended June 30, 2021. The future impact of COVID-19 uncertainties could generate, in future reporting periods, a significant impact to the reported amounts of assets, liabilities, revenue and expenses in these and any future financial statements.

Critical judgments that management has made in applying KWESST’s accounting policies that have the most significant effect on the amounts recognized in the condensed consolidated interim financial statements includes the assessment of KWESST’s ability to continue as a going concern (Note 2(a)).

Significant areas having estimation uncertainty in applying accounting policies that have the most significant effect on the amounts recognized in the financial statements are the same as those that applied to the audited consolidated financial statements as at and for the period ended September 30, 2020.

3. Significant accounting policies

During the three and nine months ended June 30, 2021, the accounting policies in these condensed consolidated interim financial statements are the same as those applied in KWESST’s consolidated financial statements as at and for the period ended September 30, 2020, except as noted below.

In light of reporting inventories at June 30, 2021, KWESST added the following new accounting policy:

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

Inventories

KWESST's inventories 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 labor, 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.

Additionally, KWESST has expanded its revenue recognition accounting policy as follows:

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 can 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.

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.

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.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

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.

4. Asset 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, subject to four-month hold (August 29, 2021); 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 2022. At closing of the acquisition, KWESST made an upfront payment of \$150,000 as an advance on future royalty payments.

The minimum annual royalty payments are as follows:

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

The royalty payment obligation of the Purchase Agreement (“Agreement”) will expire in 20 years unless terminated earlier under the terms set out in the Agreement. At its sole discretion, KWESST may

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

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 allocation was determined as follows:

	Number	Fair Value
Common shares	1,000,000	\$ 1,290,000
Warrants	500,000	\$ 425,000
Minimum royalty payments		\$ 1,090,732
Total		\$ 2,805,732

Identifiable intangible assets

Technology asset	\$ 2,805,732
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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 16% per annum.

During the quarter ended June 30, 2021, KWESST recorded \$25,567 of accretion cost relating to the discounted minimum royalty payments, which is included in net finance costs in the condensed consolidated interim statement of net loss and comprehensive loss.

b) 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

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

(vi) pay royalties up to US\$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 forfeited. 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 US\$3million. Thereafter, the royalty rate will decrease to 5%. The obligation to pay royalties will terminate automatically once KWESST has paid SageGuild a total of US\$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 the 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.

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⁾		\$ 133,680
Contingent consideration		\$ 180,000
Total		\$ 481,472

Identifiable intangible assets

Technology asset	\$ 481,472
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(1) In September 2020, KWESST elected to issue 557,000 common shares rather than to pay US\$100,000. These shares were issued in September 2020 and accordingly, these are not included in the total outstanding common shares at June 30, 2020.

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 US\$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

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

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.

5. Trade and other receivables

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

	June 30, 2021	September 30, 2020
		(as restated)
Trade receivables	\$ 87,095	\$ 209,169
Unbilled revenue	175,858	-
Sales tax recoverable	194,384	144,423
Investment tax credits refundable	-	127,325
Total	\$ 457,337	\$ 480,917

There was no impairment of trade and other receivables during the nine months ended June 30, 2021 (2020 – \$nil).

6. Inventories

The following table presents a breakdown of inventories:

	June 30, 2021	September 30, 2020
Work-in-progress	\$ 474,805	\$ -
Raw materials	75,123	-
Total	\$ 549,928	\$ -

There was no impairment of inventories during the nine months ended June 30, 2021 (2020 – \$nil).

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

7. Property and equipment

The following is summary of changes in property and equipment:

Cost	Computer equipment	Computer software	Office furniture and equipment	R&D equipment	Leasehold improvements	Total property and equipment
Balance, September 30, 2020	\$ 32,807	\$ 8,145	\$ 81,838	\$ 53,638	\$ 59,090	\$ 235,518
Additions	20,880	-	11,299	29,583	58,147	119,909
Balance at June 30, 2021	\$ 53,687	\$ 8,145	\$ 93,137	\$ 83,221	\$ 117,237	\$ 355,427

Accumulated depreciation	Computer equipment	Computer software	Office furniture and equipment	R&D equipment	Leasehold improvements	Total property and equipment
Balance, September 30, 2020	\$ 6,062	\$ 7,637	\$ 22,292	\$ 20,838	\$ 4,045	\$ 60,874
Amortization for the period	9,729	508	14,524	9,146	7,736	41,643
Balance at June 30, 2021	\$ 15,791	\$ 8,145	\$ 36,816	\$ 29,984	\$ 11,781	\$ 102,517
Carrying value at September 30, 2020	\$ 26,745	\$ 508	\$ 59,546	\$ 32,800	\$ 55,045	\$ 174,644
Carrying value at June 30, 2021	\$ 37,896	\$ -	\$ 56,321	\$ 53,237	\$ 105,456	\$ 252,910

8. Right-of-use assets

The following table presents the changes in right-of-use assets:

	Offices	Printer	Total right-of-use assets
Balance at September 30, 2020 (previously reported)	\$ 517,161	\$ 3,279	\$ 520,440
Correction of an error	(192,864)	-	(192,864)
Balance at September 30, 2020 (as restated)	324,297	3,279	327,576
Depreciation	(43,562)	(3,279)	(46,841)
Balance at June 30, 2021	\$ 280,735	\$ -	\$ 280,735

During the quarter, management made an adjustment for a correction in the application of IFRS 16, *Leases*, to the new office lease entered in March 2020. The following summarizes the effects of this correction to these interim financial statements.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

Condensed consolidated interim statements of financial position as at September 30, 2020:

	Previously		Adjusted
	Reported	Adjustment	
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)

Condensed consolidated interim statements of changes in shareholders' equity (deficit) as at September 30, 2020:

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

For the quarter ended June 30, 2020, KWESST made immaterial adjustments to depreciation and amortization, general and administrative expenses, and net finance costs to correct for the application of IFRS 16.

9. Intangible assets

The following table presents the changes in intangible assets:

	Development	Technology	Total
	Costs	Assets	
Cost			
Balance at September 30, 2020	\$ 163,230	\$ 481,472	\$ 644,702
Transferred to inventories	(107,854)	-	(107,854)
Impairment charge	(55,376)	-	(55,376)
Acquired LEC System	-	2,805,732	2,805,732
Balance at June 30, 2021	\$ -	\$ 3,287,204	\$ 3,287,204

Refer to Note 4 for details relating to the acquired technology assets. As the Phantom™ System and LEC System have not yet reached commercialization (both reported under Technology Assets), no amortization charge was recorded for the nine months ended June 30, 2021 (2020 - \$nil).

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

10. Accounts payable and accrued liabilities

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

	June 30, 2021	September 30, 2020
Trade payable	\$ 610,869	\$ 493,027
Salary and vacation payable	182,534	65,722
Accrued liabilities	145,494	188,265
Payroll taxes payable	25,158	67,229
Other	-	4,031
Total	\$ 964,055	\$ 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 32.6% of the issued and outstanding common shares of KWESST at June 30, 2021.

Key management personnel compensation comprised the following:

	Nine months ended June 30, 2021	Nine months ended June 30, 2020
Wages and benefits	\$ 309,752	\$ 102,343
Consulting fees	135,000	156,000
Directors compensation	62,500	-
Share-based compensation	559,156	25,027
Total	\$ 1,066,408	\$ 283,370

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 for the former Chief Financial Officer.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

Related party loans

The following table summarizes the related party loans.

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

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

Other related party transactions:

- In November 2019, KWESST hired SageGuild LLC to assist the Company in promoting its product offerings in the United States (see also Note 4(b)). In January 2021, the 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 \$111,269 and \$226,797 for business development costs during the three and nine months ended June 30, 2021, respectively.
- Two directors of KWESST were investors in the 2019 convertible notes, in which KWESST incurred finance costs of \$2,323 and \$6,322 on these convertible notes for the three and nine months ended June 30, 2020. These were subsequently converted to common shares of KWESST in September 2020.
- The lease for a 3-D printer was with a private company owned by KWESST's President and CEO and his spouse, which was fully repaid in Fiscal 2020 (see Note 13).

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

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

12. Borrowings

	CEBA Term Loan	Unsecured Loan	Total
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	3,228	4,527	7,755
Repayment	-	(310,527)	(310,527)
Balance, June 30, 2021	\$ 51,987	\$ -	\$ 51,987
Current	\$ -	\$ -	\$ -
Non-current	51,987	-	51,987
Total	\$ 51,987	\$ -	\$ 51,987

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. 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 in the condensed consolidated interim statements of financial position. The additional CEBA Term loan was initially recorded at fair value, discounted using its incremental borrowing rate of 10%. This resulted in recording a gain on government grant of \$3,514 for the six months ended March 31, 2021.

The CEBA Term Loan may be repaid at any time without notice or the payment of any penalty. If 75% of the CEBA Term Loan is repaid on or before December 31, 2022, the repayment of the remaining 25% 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 initially recorded the loan at fair value, without taking into account the potential forgivable amount. For the nine months ended June 30, 2021, KWESST recognized \$3,514 gain on government grant.

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 loan is due on demand and bears interest at 0.5% per month. On May 27, 2021, KWESST repaid the loan, including accrued interest, for a total of \$310,527.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

13. Lease obligations

During the quarter ended June 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 2022.

When measuring the lease obligation, the Company discounted the remaining lease payments using the incremental 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 restated)	\$ 352,037	\$ -	\$ 352,037	\$ 44,128	\$ 307,909
Lease payments (including interest)	(54,600)		(54,600)		
Interest expense	25,916		25,916		
Balance at June 30, 2021	\$ 323,353	\$ -	\$ 323,353	\$ 31,494	\$ 291,859

Refer to Note 8 regarding the correction of an error.

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 a gain of \$17,528. This was included in the net finance costs for the three and nine months ended June 30, 2020 (see Note 17).

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

	June 30, 2021	September 30, 2020
Less than one year	\$ 62,400	\$ 78,000
One to five years	351,000	390,000
Total	\$ 413,400	\$ 468,000

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

14. Shareholders' Equity

Share Capital

Authorized

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

The following shows the share capital activities for the nine months period ended June 30, 2021, and 2020:

Issued Common Shares

	Number	Fair Value	Amount
Balance, September 30, 2019	18,700,200		\$ 648,508
Issued for converted debt and accrued interest	3,104,486	\$ 0.200	620,897
Issued in private placement	5,075,000	\$ 0.200	1,014,948
Issued in private placement	2,625,000	\$ 0.400	1,050,000
Issued in private placement	861,750	\$ 0.500	430,875
Issued for consulting services	61,000	\$ 0.531	32,393
Issued in asset acquisition	140,000	\$ 0.240	33,600
Issued for exercise of stock options	61,000	\$ 0.640	39,040
less: share offering costs			(130,707)
Outstanding at June 30, 2020	30,628,436		\$ 3,739,554
Balance, September 30, 2020	41,266,176		\$ 9,374,563
Issued for debt settlements	91,356	\$ 0.700	63,949
Issued for exercise of stock options	854,884	\$ 0.861	736,419
Issued for exercise of warrants	423,899	\$ 0.520	220,220
Issued for share units	2,235	\$ 1.290	2,883
Issued for asset acquisition	1,000,000	\$ 1.290	1,290,000
Issued for amended license (see Note 20)	100,000	\$ 1.370	137,000
Issued in brokered private placement	3,536,057	\$ 1.010	3,571,418
Outstanding at June 30, 2021	47,274,607		\$ 15,396,452
Less: share offering costs			(693,905)
Net share capital at June 30, 2021			\$ 14,702,547

Asset Acquisition

During the quarter ended June 30, 2021, KWESST acquired the LEC System technology resulting in the issuance of 1 million common shares and 500,000 warrants (see Note 4(a)).

Brokered Private Placement

On April 29, 2021, KWESST closed its previously announced over-subscribed brokered private placement, resulting in the issuance of 3,536,057 units ("Units") of KWESST, at a price of \$1.25 per Unit (the "Issue Price"), for aggregate gross proceeds of \$4,420,071 (the "Offering").

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

Under the Offering, KWESST sold a total of 3,536,057 units at a price of \$1.25 per Unit. Each Unit is comprised of one common share of the Company (a "Common Share") and one Common Share purchase warrant ("Warrant"). Each Warrant is exercisable to acquire one Common Share (a "Warrant Share") at a price of \$1.75 per Warrant Share for a period of 24 months from the closing of the Offering. If at any time after four (4) months and one (1) day following the Closing Date, the trading price of the Shares 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 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. Directors and officers of KWESST purchased 72,000 Units for a total consideration of \$90,000.

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 warrants. Because the warrants include an accelerator provision for expiration, management used the Barrier option model to estimate the fair value of these warrants, using the following key inputs:

Strike Price	\$	1.75
Stock price	\$	1.01
Volatility		80%
Dividend Yield		Nil
Risk-free interest rate		0.31%
Barrier (accelerator on life of warrants)	\$	3.00
Rebate	\$	1.25
Expected life		2
Weighted average fair value per warrant	\$	0.24

Accordingly, management has estimated a fair value of \$0.24 per warrant. As a result, \$1.01 of the \$1.25 consideration was allocated to common shares.

The total cash and non-cash share offering costs were \$630,680 for the Offering, which is recorded as a reduction of share capital.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

Warrants

The following is a summary of changes in outstanding warrants since September 30, 2020.

	# of Warrants	Exercise Price	Fair Value	Weighted average remaining life (years)	Expiry Date
Warrants outstanding at September 30, 2020	9,585,050		\$ 277,170	3.22	
Exercised	(250,000)	\$ 0.50	\$ (60,000)		June 15 2023
Exercised	(15,000)	\$ 0.40	\$ (2,265)		January 30 2022
Exercised	(158,899)	\$ 0.70	\$ (40,726)		July 9 2022
Issued in brokered private placement	3,536,057	\$ 1.75	\$ 848,654	1.83	April 29 2023
Issued in LEC asset acquisition	500,000	\$ 0.70	\$ 425,000	4.83	April 29 2026
Warrants outstanding at June 30, 2021	13,197,208	\$ 0.65	\$ 1,447,833	2.43	
Warrants exercisable at June 30, 2021	12,197,208	\$ 0.65		2.46	

As previously noted, management estimated \$0.24 for the fair value of the warrants issued in the brokered private placement.

For the warrants issued to DEFSEC relating to the LEC System acquisition (Note 4(a)), management estimated a fair value of \$0.85 per warrant using the Black-Scholes option model with the following key inputs: a) exercise price of \$0.70, b) underlying stock price of \$1.29, c) estimated volatility of 80%, d) risk free interest rate of 0.48%, and e) estimated life of 3 years.

See Note 19 for non-cash transaction relating to the exercise of warrants.

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 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 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.

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%.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

Accordingly, KWESST recorded \$169,832 of Compensation Options in contributed surplus, with an equal offset to share offering costs (a non-cash transaction).

Share-Based Compensation

a) Stock Options

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 shall not exceed 4,226,737 shares. The LTIP is subject to annual shareholder approval at the Annual General and Special Meeting.

At June 30, 2021, the remaining stock option pool was 1,055,409 options and there were 4,187,977 RSUs, DSUs, SARs, and PSUs available for grant under KWESST's LTIP.

The following is summary of changes in outstanding options since September 30, 2020.

	Number of options	Weighted average exercise price
Outstanding at September 30, 2020	2,018,714	\$ 0.65
Granted	2,758,223	\$ 1.40
Exercised	(854,884)	\$ 0.62
Cancelled	(250,000)	\$ 0.70
Outstanding at June 30, 2021	3,672,053	\$ 1.22
Options exercisable at June 30, 2021	1,911,084	\$ 1.08

During the nine months period ended June 30, 2021, KWESST granted 2,758,223 options to directors, officers, employees and consultants at a weighted average exercise price of \$1.40. At June 30, 2021, the weighted average remaining vesting period was 1.25 years.

For the options granted during the nine months ended June 30, 2021, the per share weighted-average fair value of stock options was \$0.65, using the Black-Scholes option model with the following weighted-average assumptions:

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
 Three and nine months ended June 30, 2021 and 2020
 (Expressed in Canadian dollars, except share and per share amounts)

Volatility	74.89%
Dividend Yield	Nil
Risk-free interest rate	0.22%
Expected life (years)	2.76

Weighted-average fair value per option \$ 0.65

The following table summarizes information about stock options outstanding at June 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	963,928	3.76	\$ 0.66	810,303	3.78	\$ 0.66
\$0.71 to \$1.15	1,015,625	4.42	\$ 0.92	503,906	4.42	\$ 0.92
\$1.16 to \$1.60	437,500	4.82	\$ 1.31	106,250	4.81	\$ 1.32
\$1.61 to \$2.05	1,005,000	4.27	\$ 1.76	365,625	4.29	\$ 1.75
\$2.06 to \$2.50	250,000	4.60	\$ 2.28	125,000	4.60	\$ 2.28
	3,672,053	4.27	\$ 1.22	1,911,084	4.16	\$ 1.08

Amendment to stock option grants

During the nine months ended June 30, 2021, the Board approved the acceleration of vesting for 385,500 options and the cancellation of 250,000 options. This resulted in an additional stock-based compensation charge of \$65,813.

b) Restricted Stock Units ("RSUs")

During the quarter ended June 30, 2021, the Board granted 38,760 RSUs to two officers, vesting over 12 months.

For the three and nine months ended June 30, 2021, KWESST recorded stock-based compensation expenses (stock options and RSUs) of \$520,423 (2020 – \$125,296) and \$1,398,881 (2020 - \$145,962), respectively.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
 Three and nine months ended June 30, 2021 and 2020
 (Expressed in Canadian dollars, except share and per share amounts)

15. Loss per share

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

	Three months ended June 30, 2021	Three months ended June 30, 2020	Nine months ended June 30, 2021	Nine months ended June 30, 2020
Issued common shares, beginning of period	42,507,387	30,350,436	41,266,176	18,700,200
<i>Effect of shares issued from:</i>				
Debt settlements	-	-	66,364	-
Exercised options	54,816	-	484,936	-
Conversion of stock units	1,954	-	499	-
Services rendered	-	12,066	-	4,007
Private placements	2,460,310	3,165	803,061	1,756,663
Exercised warrants	-	-	253,502	-
Conversion of convertible notes, including interest	-	-	-	1,390,374
Asset acquisitions	888,667	27,692	227,106	9,197
Amended license	103,511	-	24,908	-
Weighted average number of basic common shares	46,016,645	30,393,359	43,126,552	21,860,441
<i>Dilutive securities:</i>				
Stock options	-	-	-	-
Warrants	-	-	-	-
Weighted average number of dilutive common shares	46,016,645	30,393,359	43,126,552	21,860,441

At June 30, 2021, and 2021, all the warrants, stock options and broker compensation options were anti-dilutive because of KWESST's net loss for the above periods.

16. Revenue

The following table presents a breakdown of revenue for KWESST:

	Three months ended June 30, 2021	Three months ended June 30, 2020	Nine months ended June 30, 2021	Nine months ended June 30, 2020
TASCs System	\$ 497,792	\$ 596,439	\$ 1,080,933	\$ 631,719
Other	23,932	4,035	34,824	21,455
	\$ 521,724	\$ 600,474	\$ 1,115,757	\$ 653,174

At June 30, 2021, KWESST's contracted not yet recognized revenue was approximately \$146,542, of which 100% of this amount is expected to be recognized over the next six months.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

17. Net finance costs

The following table presents a breakdown of net finance costs:

	Quarter ended June 30,		Nine months ended June 30,	
	2021	2020	2021	2020
Interest expense from:				
Lease obligations	\$ (2,891)	\$ 15,734	\$ 25,916	\$ 40,257
Accretion cost - accrued royalties liability	25,567	-	25,567	-
Related party loans	628	2,513	4,581	13,312
Unsecured loan	2,817	-	4,527	-
CEBA term loan	1,221	-	3,228	-
2019 convertible notes	-	9,683	-	48,911
2020 convertible notes	-	63,553	-	63,553
Other	1,042	7,590	3,784	10,418
Total interest expense	28,384	99,073	67,603	176,451
Interest income	(604)	-	(3,232)	(237)
Gain on termination of lease obligation	-	(17,527)	-	(17,527)
Net finance costs	\$ 27,780	\$ 81,546	\$ 64,371	\$ 158,687

18. Financial instruments

Fair value of financial instruments

The fair values of cash, restricted short-term investment, trade and other receivables, and accounts payables and accrued liabilities approximate carrying value because of the short-term nature of these instruments.

The carrying value of the borrowings and lease obligations approximate their fair value based on market rates of interest.

The carrying value of the accrued royalties liability is based on estimated fair value, using the income approach.

In the prior year, KWESST had outstanding convertible notes. In connection with the issuance of the 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 this financial derivative. This resulted in recording an unrealized loss of \$89,489 and \$64,948 for the three and nine months ended June 30, 2020.

Financial risk management

The Company is exposed to a number of financial risks arising through the normal course of business as well as through its financial instruments. The Company'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.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

(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. KWESST's borrowings have fixed interest rate terms and therefore KWESST is not exposed to interest rate risk.

(b) Foreign currency risk

Foreign currency risk is the risk that the future cash flows or fair value of the Company'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.

Historically, KWESST's revenue was substantially denominated in US dollar driven by contracts with U.S. prime contractors in the defense sector. Accordingly, KWESST is exposed to fluctuations in the US dollar currency. A significant change in the US dollar currency could have a significant effect on KWESST's financial performance, financial position and cash flows. At this time, KWESST does not use derivative instruments to hedge its US dollar exposure.

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

	Total USD
Net assets in U.S. subsidiary	\$ 192,833
US denominated:	
Assets	\$ 283,730
Liabilities	(130,025)
Net US dollar exposure at June 30, 2021	\$ 346,538
Impact to profit or loss if 5% movement in the US dollar	\$ 17,327

During the three and nine months ended June 30, 2021, KWESST recorded foreign exchange loss of \$9,025 and \$14,189 (2020 – loss of \$14,549 and \$9,727), respectively.

(c) Credit risk

Credit risk is the risk of financial loss to the Company 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. The counterparty for the trade and other receivables is the Canadian government and a U.S. military customer.

(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. KWESST's working capital at June 30, 2021 was approximately \$2.8 million (refer to Note 2(a)).

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

19. Supplemental cash flow information

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

	Nine months ended June 30, 2021	Nine months ended June 30, 2020
Trade and other receivables	\$ 23,580	\$ (208,363)
Inventories	(442,074)	-
Prepaid expenses and other	36,979	(304,643)
Accounts payable and accrued liabilities	(876,121)	539,743
Deferred revenue	(7,053)	-
Deposits	150,000	-
Accrued royalties liability	1,116,299	-
	\$ 1,610	\$ 26,737

The following is a summary of non-cash items that were excluded from the Statements of Cash Flows for the nine months ended June 30, 2021:

- \$63,949 debt settlement via common shares;
- \$125,000 for 250,000 exercised warrants in connection with the GhostStep™ technology acquisition in June 2020 (Note 4(b));
- \$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 20); and
- \$169,832 share offering costs relating to the Broker Compensation Options (Note 14).

20. Commitments and contingencies

Minimum royalties

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. Because there is significant uncertainty over the timing of receiving a functioning prototype from AerialX and the related future sales to assess recoverability, KWESST recorded the \$137,000 fair value as a license cost for the quarter ended June 30, 2021, with an equal offset to KWESST’s share capital.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

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 quarter ended June 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:

# 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. Minimum payments will be as follows:

- 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. In accordance with IFRS, during the quarter 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 was included in the royalty and licensing costs 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.

21. Research and Development

The following table shows the breakdown of R&D consulting and material, net:

	Three months ended June 30, 2021	Three months ended June 30, 2020	Nine months ended June 30, 2021	Nine months ended June 30, 2020
R&D consulting & material costs	\$ 165,935	\$ 94,130	\$ 440,965	\$ 274,908
Less: Investment tax credits	-	(67,325)	(24,245)	(67,135)
R&D consulting & material costs, net	\$ 165,935	\$ 26,805	\$ 416,720	\$ 207,773

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2021 and 2020
(Expressed in Canadian dollars, except share and per share amounts)

22. Segmented information

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

Geographic information

The following table presents external revenue on a geographic basis:

	Three months ended June 30, 2021	Three months ended June 30, 2020	Nine months ended June 30, 2021	Nine months ended June 30, 2020
United States	\$ 497,792	\$ 596,439	\$ 1,080,933	\$ 631,719
Canada	23,932	4,035	34,824	21,455
	\$ 521,724	\$ 600,474	\$ 1,115,757	\$ 653,174

All of KWESST's property and equipment are located in Canada, including the right-of-use assets.

Concentration of customers information

For the three and nine months ended June 30, 2021, one customer accounted for the revenue based in the United States (2020 – two customers) and one customer accounted for 72% and 97% of the revenue based in Canada for the three and nine months ended June 30, 2021 (2020 – no concentration).

23. Subsequent events

a) Stock-based compensation

Since June 30, 2021, 252,225 stock options and 5,340 warrants were exercised for total proceeds of \$237,509.

In July 2021, KWESST granted 50,000 PSUs and 405,000 stock options to officers and employees with exercise price ranging from \$1.13 to \$1.25, to be vested 25% each six months and expiring in five years. Additionally, KWESST granted 460,000 RSUs to officers and a consultant, vesting over 12 months.

Additionally, on July 20, 2021, KWESST entered into a promotion agreement with The Officer Tatum, LLC whereby Brandon Tatum will act as an advisor and be an advocate of KWESST's LEC System. In addition to consulting fees payable in cash, KWESST issued the following to The Officer Tatum, LLC:

- 150,000 PSUs, vesting subject to performance milestones as defined in the agreement;
- 350,000 RSUs, with 87,500 RSUs vesting on April 22, 2022, July 22, 2022, October 22, 2022, and January 22, 2023; and
- 150,000 share appreciation rights (SARs) exercisable at \$1.65, with 50,000 SARs vesting on October 10, 2021, December 31, 2021, and January 22, 2022.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements

Three and nine months ended June 30, 2021 and 2020

(Expressed in Canadian dollars, except share and per share amounts)

b) Brokered private placement

Subsequent to June 30, 2021, the Lead Agent (PI Financial) discovered it had erroneously omitted one subscription of 40,000 units or \$50,000 from the Offering (see Note 14). Following TSX-V approval on an exception basis, KWESST accepted this additional subscription in August 2021.