

Condensed Interim Financial Statements of

KWESST INC.

Three and six months ended June 30, 2020, and 2019

(Unaudited – in Canadian dollars)

These unaudited condensed interim financial statements of KWESST Inc. for the three and six months ended June 30, 2020 and 2019 have been prepared by management and approved by the Board of Directors on November 17, 2020. These unaudited condensed interim financial statements have not been reviewed by the Company's external auditors.

KWESST Inc.

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KWESST INC.
Condensed Statements of Financial Position
(Unaudited)

<i>In Canadian dollars</i>	<i>Note</i>	June 30, 2020	December 31, 2019
ASSETS			
Cash		\$ 1,275,351	\$ 21,615
Trade and other receivables	5	264,104	219,803
Prepaid expenses and other		393,857	54,075
Current assets		1,933,312	295,493
Property and equipment	6	137,738	70,122
Right-of-use assets	7	543,613	184,472
Intangible assets	8, 9	855,520	-
Non-current assets		1,536,871	254,594
Total Assets		\$ 3,470,183	\$ 550,087
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)			
Liabilities			
Accounts payable and accrued liabilities	10	\$ 561,319	\$ 198,687
Convertible notes	11	908,210	-
Subscription deposits	12	383,500	-
Related party loans	13	240,941	289,828
Financial derivative liabilities	14	207,409	29,463
Borrowings	15	40,000	-
Lease obligations	16	7,511	85,468
Current liabilities		2,348,890	603,446
Lease obligations	16	560,312	117,218
Convertible notes	11	230,184	210,819
Non-current liabilities		790,496	328,037
Total Liabilities		3,139,386	931,483
Shareholders' Equity (Deficit)			
Share capital	17	4,045,980	2,284,353
Contributed surplus	17	391,355	21,050
Accumulated deficit		(4,106,538)	(2,686,799)
Total Shareholders' equity (deficit)		330,797	(381,396)
Total Liabilities and Shareholders' Equity (Deficit)		\$ 3,470,183	\$ 550,087

See accompanying notes to condensed interim financial statements.

KWESST INC.
Condensed Statements of Comprehensive Loss
For the three and six months ended June 30, 2020 and 2019
(Unaudited)

<i>In Canadian dollars</i>	<i>Note</i>	Three Months Ended June 30,		Six Months Ended June 30,	
		2020	2019	2020	2019
Revenue		\$ 600,474	\$ 112,694	\$ 649,433	\$ 122,872
Cost of sales		(9,879)	(17,650)	(138,536)	(31,637)
Gross profit		590,595	95,044	510,897	91,235
Operating expenses					
Personnel costs		327,067	195,542	509,613	302,277
Consulting fees		131,300	85,000	231,664	170,000
Business development		127,451	-	199,496	-
Research and development ("R&D")		94,130	-	131,336	-
Stock-based compensation	17	93,018	-	113,570	-
Travel and conferences		35,121	2,915	111,844	8,093
Depreciation and amortization	6,7,9	65,834	80,339	100,135	129,943
Professional fees		62,885	-	86,538	-
Merger and acquisition costs		81,907	-	81,907	-
Advertising and promotion		30,840	7,786	41,708	7,786
Investor relations		38,688	-	38,688	-
General and administrative expenses		25,236	10,332	37,375	20,189
Insurance		9,161	6,106	17,647	15,265
R&D tax credits		(67,325)	-	(67,325)	-
Total operating expenses		1,055,313	388,020	1,634,196	653,553
Operating loss		(464,718)	(292,976)	(1,123,299)	(562,318)
Other income (expenses)					
Fair value adjustments on derivatives	14	(89,489)	(46,165)	(177,946)	(20,737)
Net finance income (costs)	11, 16	(84,449)	(43,958)	(109,359)	(105,245)
Foreign exchange gain (loss)		(14,549)	31,830	(9,135)	31,655
Total other income (expenses)		(188,487)	(58,294)	(296,440)	(94,328)
Loss before income taxes		(653,205)	(351,270)	(1,419,739)	(656,646)
Income tax recovery (expense)		-	-	-	-
Net loss and comprehensive loss		\$ (653,205)	\$ (351,270)	\$ (1,419,739)	\$(656,646)
Net Loss per share					
Basic and diluted		\$ (0.02)	\$ (0.03)	\$ (0.05)	\$ (0.03)
Weighted average number of shares outstanding					
Basic and diluted		30,743,298	17,200,200	29,719,182	6,635,542

See accompanying notes to condensed interim financial statements.

KWESST INC.**Condensed Statements of Changes in Shareholders' Equity****For the six months ended June 30, 2020 and June 30, 2019****(Unaudited)**

<i>In Canadian dollars</i>	Note	Common Shares		Contributed		Total Shareholders' Equity
		Number Issued	Share Capital	surplus	Deficit	
Balance, December 31, 2018		200	\$ 200	\$ -	\$ (1,389,519)	\$ (1,389,319)
Shares issued for debt		17,200,000	498,308	1,192	-	499,500
Warrants issued for debt		-	-	19,858	-	19,858
Net loss		-	-	-	(656,646)	(656,646)
Balance, June 30, 2020		17,200,200	\$ 498,508	\$ 21,050	\$ (2,046,165)	\$ (1,526,607)
Balance, December 31, 2019		26,879,686	\$ 2,284,353	\$ 21,050	\$ (2,686,799)	\$ (381,396)
Shares and warrants issued in private placements	17	3,486,750	1,480,875	16,836	-	1,497,711
Shares issued for inducement bonus in private placement	11, 17	600,839	270,377	-	-	270,377
Shares and warrants issued on acquisition of technology asset	8, 17	140,000	70,000	248,089	-	318,089
Stock options exercised	17	61,000	38,690	(8,190)	-	30,500
Share-based payments	17	61,000	32,392	113,570	-	145,962
Share offering costs	17	-	(130,707)	-	-	(130,707)
Net loss		-	-	-	(1,419,739)	(1,419,739)
Balance, June 30, 2020		31,229,275	\$ 4,045,980	\$ 391,355	\$ (4,106,538)	\$ 330,797

See accompanying notes to condensed interim financial statements.

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Condensed Statements of Cash Flows

For the six month period ended June 30, 2020 and year ended December 31, 2019

(Unaudited)

<i>In Canadian dollars</i>	Note	Six months ended June 30, 2020	Year ended December 31, 2019
OPERATING ACTIVITIES			
Net loss		\$ (1,419,739)	\$ (1,297,280)
<i>Items not affecting cash:</i>			
Depreciation and amortization	6, 7, 9	100,136	102,142
Fair value adjustments on derivative liabilities	14	177,946	(113,178)
Share-based compensation	17	145,962	-
Net finance costs		109,359	230,858
<i>Changes in non-cash working capital items:</i>			
Prepaid expenses		(346,628)	(36,629)
Trade and other receivables		(44,301)	(41,465)
Accounts payable and accrued liabilities		359,090	86,519
Other assets		-	-
Cash used in operating activities		(918,175)	(1,069,033)
INVESTING ACTIVITIES			
Acquisition of property and equipment	6	(95,076)	(20,190)
Acquisition of technology asset	8	(134,192)	-
Investments in development projects	9	(98,563)	-
Investments in patents	9	(26,176)	-
Cash flows used in investing activities		(354,007)	(20,190)
FINANCING ACTIVITIES			
Proceeds (repayment) from borrowings	15	40,000	-
Repayment of borrowings		-	(10,747)
Proceeds from subscription deposits	12	105,000	-
Proceeds from the issuance of common shares	17	1,480,875	1,014,948
Repayments to related party loans	13	(55,000)	(70,513)
Proceeds from related party loans		-	310,684
Repayments of lease obligations		(43,090)	(101,890)
Proceeds of convertible notes	11	1,081,504	-
Repayments of convertible notes		-	(31,644)
Proceeds from exercise of stock options	17	30,500	-
Payments of share offering costs	17	(113,871)	-
Cash flows provided by financing activities		2,525,918	1,110,838
Net change in cash during the year		1,253,736	21,615
Cash and cash equivalents, beginning		21,615	-
Cash and cash equivalents, ending		\$ 1,275,351	\$ 21,615

See Note - 19 for supplemental cash flow information

See accompanying notes to condensed interim financial statements.

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Notes to Unaudited Condensed Interim Financial Statements

Three and six months ended June 30, 2020

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

1. Nature of Business and Operations

(a) Nature of Business and Operations

KWESST Inc. (the "Company" or "KWESST"), was incorporated under the laws of the Province of Ontario on April 24, 2017. The Company's corporate office is located at Unit 1, 155 Terrence Matthews Crescent, Ottawa, Ontario, Canada. At June 30, 2020, the Company had no subsidiaries.

KWESST develops and markets innovative products to create "intelligent tactical systems" and proprietary technology for game-changing applications in the military and homeland security market. KWESST's core technology has multiple applications based on its micro integrated sensor software technology, or MISST, a proprietary integration of miniaturized sensors, optics, ballistics and software that provides an advancement in affordable smart systems and mission capability.

2. Basis of preparation

(a) Statement of compliance

These condensed 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 disclosures that would otherwise be required for a complete set of financial statements and should be read in conjunction with the annual audited financial statements of KWESST's for the year ended December 31, 2019.

These unaudited condensed interim financial statements were authorized for issue by the Board of Directors on November 17, 2020.

(b) Basis of presentation

The Company does not have any subsidiaries and is wholly owned by 2573685 Ontario Inc, a company incorporated under the laws of the Province of Ontario (see Note 20, Subsequent Events).

The preparation of condensed interim financial statements in conformity with IAS 34 requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. Actual results may differ from these estimates.

(c) Functional and presentation currency

These financial statements are presented in Canadian dollars ("CAD"), KWESST's functional currency and presentation currency.

(d) Basis of measurement

These financial statements have been prepared on the historical cost basis.

(e) Comparative figures

Certain comparative figures in the Statements of Comprehensive Loss have been reclassified to conform with the current period's presentation.

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(f) Use of estimates and judgments

In preparing these unaudited condensed interim financial statements, management makes judgments, estimates, and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expense. Actual results may differ from these estimates.

COVID-19

The continuing uncertainty around the outbreak of the novel coronavirus (“COVID-19”) pandemic required the use of judgements and estimates in the preparation of the unaudited condensed interim financial statements for the period ended June 30, 2020. 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. Example of accounting estimates and judgments that may be impacted by the pandemic include, but are not limited to:

- Revenue recognition;
- Impairment of intangible assets; and
- Useful lives of property and equipment.

The significant judgements made by management in applying KWESST’s accounting policies and the key sources of estimation uncertainty were the same as those that applied to the audited financial statements as at and for the year ended December 31, 2019.

3. Significant accounting policies

During the six months ended June 30, 2020, the accounting policies in these condensed interim financial statements are the same as those applied in KWESST’s financial statements as at and for the year ended December 31, 2019, except for the following new accounting policies implemented in 2020:

Intangible Assets

(i) Research and development 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.

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(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 reflect 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.

Definition of a business (Amendments to IFRS 3)

On January 1, 2020, we adopted IFRS 3, *Definition of a Business (Amendments to IFRS 3)*, which clarifies the definition of a business for the purpose of determining whether a transaction should be accounted for as an asset acquisition or a business acquisition. The amendments were as follows:

- (i) Clarified the minimum attributes that the acquired assets and activities must have to be considered a business;
- (ii) Removed the assessment of whether market participants can acquire the business and replace missing inputs or processes to enable them to continue to produce outputs;
- (iii) Narrowed the definition of a business and the definition of outputs; and
- (iv) Added an optional concentration test that allows a simplified assessment of whether an acquired set of activities and assets is not a business.

The adoption of Amendments to IFRS 3 had no impact to KWESST's condensed interim financial statements. See Note 8 Asset Acquisition.

4. New accounting standards issued but not yet in effect

Classification of liabilities as current or non-current (Amendments to IAS 1)

The IASB has published *Classification of Liabilities as Current or Non-Current (Amendments to IAS 1)*, which clarified the guidance on whether a liability should be classified as either current or non-current. The amendments were as follows:

- (i) Clarified that the classification of liabilities as current or non-current should only be based on rights that are in place at the *end of the reporting period*.
- (ii) Clarified that classification is unaffected by expectations about whether an entity will exercise its right to defer settlement of a liability; and

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- (iii) Made clear that settlement includes transfers to the counterparty of cash, equity instruments, other assets or services that result in extinguishment of the liability.

This new guidance is effective for annual periods beginning on or after January 1, 2022. Earlier application is permitted. KWESST has not yet assessed the impact of adoption of this guidance. Further, there is currently a proposal outstanding that would defer the effective date until January 1, 2023.

5. Trade and other receivables

The following table presents trade and other receivables for KWESST:

	June 30, 2020	December 31, 2019
Trade accounts receivable	\$ 173	\$ 1,191
Unbilled receivables	102,504	-
Sales tax receivable	94,102	55,684
Investment tax credits refundable	67,325	162,928
	\$ 264,104	\$ 219,803

There was no write-off of trade and other receivables during the six months ended June 30, 2020.

The following table shows the changes in unbilled receivables for the six months ended June 30, 2020:

Unbilled receivables at December 31, 2019	\$ -
Revenue in excess of billings	102,504
Amounts transferred to trade receivable	-
Unbilled receivables at June 30, 2020	\$ 102,504

6. Property and equipment

The following is summary of changes in KWESST's property and equipment since December 31, 2019:

Cost	Computer equipment	Computer software	Office furniture and equipment	R&D equipment	Leasehold improvements	Total property and equipment
Balance at December 31, 2019	\$ 14,073	\$ 8,145	\$ 32,781	\$ 46,588	\$ 8,607	\$ 110,194
Additions	6,228	-	25,151	4,607	59,090	95,076
Disposals	-	-	-	-	-	-
Balance at June 30, 2020	\$ 20,301	\$ 8,145	\$ 57,932	\$ 51,195	\$ 67,697	\$ 205,270

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	Computer equipment	Computer software	Office furniture and equipment	R&D equipment	Leasehold improvements	Total property and equipment
Accumulated depreciation						
Balance at December 31, 2019	\$ 241	6,111	16,143	13,359	4,218	40,072
Amortization	5,274	2,034	7,246	9,535	3,371	27,460
Balance at June 30, 2020	\$ 5,515	\$ 8,145	\$ 23,389	\$ 22,894	\$ 7,589	\$ 67,532
Carrying value at December 31, 2019	\$ 13,832	\$ 2,034	\$ 16,638	\$ 33,229	\$ 4,389	\$ 70,122
Carrying value at June 30, 2020	\$ 14,786	\$ -	\$ 34,543	\$ 28,301	\$ 60,108	\$ 137,738

7. Right-of-use assets

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

	Offices	Printer	Total right-of-use assets
Balance at December 31, 2019	\$ 177,911	\$ 6,561	\$ 184,472
Additions	571,604	-	571,604
Termination	(139,787)	-	(139,787)
Depreciation	(69,394)	(3,282)	(72,676)
Balance at June 30, 2020	\$ 540,334	\$ 3,279	\$ 543,613

During the first six months of 2020, KWESST terminated its lease agreement due to breach of contract by the former landlord and as a result KWESST de-recognized the related right-of-use asset and lease obligation (see Note 16).

As a result of the above, KWESST entered into a new office lease agreement with a 74-month lease term starting from March 31, 2020.

8. Asset Acquisition

On June 12, 2020, KWESST entered into the GhostStep Technology Purchase Agreement (the "Purchase Agreement") with SageGuild LLC ("SageGuild") pursuant to which KWESST acquired the GhostStep® Technology. Management determined that this transaction did not meet the definition of a business under IFRS 3 and therefore this transaction was accounted for as an asset acquisition.

The total purchase consideration ("Purchase Price") comprised of:

- (i) a cash payment made on June 12, 2020 in the amount of USD \$100,000 (CAD \$134,192);
- (ii) the issuance on June 12, 2020 of 140,000 common shares of KWESST at a deemed price of \$0.50 per common share for a value of \$70,000; and
- (iii) either the payment of USD \$100,000 in cash or the issuance of 557,000 common shares of KWESST at a deemed price of \$0.50 per common share (CAD \$278,500), at KWESST's sole discretion, upon the completion of KWESST's Qualifying Transaction.

As a result of completing the Qualifying Transaction during the third quarter of 2020 (see Note 20 – Subsequent Events), KWESST has elected to issue 557,000 common shares of KWESST to SageGuild.

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

In addition to the Purchase Price, pursuant to the Purchase Agreement KWESST has:

- (i) agreed to make annual payments (“Yearly Payments”) to SageGuild of \$125,000 on each of December 31, 2020, 2021 and 2022, subject to certain conditions; and
- (ii) issued 750,000 warrants to SageGuild exercisable at \$0.50 per share and expiring on January 15, 2023 (the “Warrants”) – see Note 17.

The 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.

Accordingly, the total purchase consideration amounted to:

Cash consideration	\$ 134,192
Share issuance with no condition	70,000
Share issuance subject to QT (see note 20)	278,500
Warrants issuance	248,089
Total purchase consideration	\$ 730,781

The above total purchase consideration was recognized as intangible assets (see Note 9).

In addition to the above total purchase consideration, KWESST has agreed to pay SageGuild royalties at a rate of 20% on amounts received in consideration of the grant of licenses and on sales of the GhostStep® Technology until KWESST has paid SageGuild a total of USD \$3 million in royalties. Once KWESST has paid SageGuild a total of USD \$3 million in royalties, 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 GhostStep® Technology 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 GhostStep® Technology back to SageGuild.

KWESST did not have any sales during the second quarter of 2020 that would have triggered royalty payments payable to SageGuild.

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9. Intangible assets

At June 30, 2020, the carrying values of KWESST's intangible assets were as follows:

	Development		Technology	
	Costs	Patents	Asset	Total
Cost				
Balance at December 31, 2019	\$ -	\$ -	\$ -	\$ -
Additions	98,563	26,176	-	124,739
Additions through acquisition	-	-	730,781	730,781
Balance at June 30, 2020	\$ 98,563	\$26,176	\$ 730,781	\$ 855,520
Accumulated amortization				
Balance at December 31, 2019	-	-	-	-
Amortization	-	-	-	-
Balance at June 30, 2020	\$ -	\$ -	\$ -	\$ -
Carrying value at June 30, 2020	\$ 98,563	\$ 26,176	\$ 730,781	\$ 855,520

During the first six months of 2020, KWESST capitalized development costs of \$98,563 in connection with a funded development project to support a U.S. military customer, featuring KWESST's signature Tactical Awareness and Situational Control System ("TASCS"). KWESST completed the first phase of three deliverables during the third quarter of 2020 and accordingly, the capitalized development costs will be charged to profit or loss in the third quarter.

As disclosed in Note 8, Asset Acquisition, KWESST acquired technology assets of \$730,781, comprising intellectual property rights, including trademark rights, of the GhostStep® Technology, an electronic decoy system.

10. Accounts payable and accrued liabilities

The following table presents the breakdown of KWESST's accounts payable and accrued liabilities:

	June 30, 2020	December 31, 2019
Trade accounts payable	\$ 312,657	\$ 126,481
Accrued liabilities	168,332	29,822
Salary and vacation payable	65,419	29,343
Other	14,911	13,041
Total	\$ 561,319	\$ 198,687

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Notes to Unaudited Condensed Interim Financial Statements

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11. Convertible notes

The following table presents the convertible notes for KWESST:

	2019 Convertible Notes	2020 Convertible Notes	Total
Balance at December 31, 2019	\$ 210,819	\$ -	\$ 210,819
Proceeds from issuance	-	1,081,504	1,081,504
Issuance in lieu of cash finder fee	-	33,530	33,530
Total issuances	-	1,115,034	1,115,034
Amount classified as equity	-	(270,377)	(270,377)
Accrued interest	11,694	24,297	35,991
Accretion expenses	7,671	39,256	46,927
Balance at June 30, 2020	\$ 230,184	\$ 908,210	\$ 1,138,394

\$1.1 million Private Placement Unsecured Convertible Notes

During the second quarter 2020, KWESST closed approximately \$1.1 million private placement of unsecured convertible notes (the "2020 Convertible Notes"). The 2020 Convertible Notes bear 15% annual interest and mature in 12 months. The 2020 Convertible Notes may be converted to KWESST's common shares at \$0.45 per share at the holder's discretion. Upon closing of a Liquidity Event, the 2020 Convertible Notes and interest accrued thereon will be automatically converted into common shares of KWESST at \$0.45 per share.

A "Liquidity Event" is defined under the agreement as either (1) the completion of an initial public offering which results in the common shares of the Company being listed and posted for trading or quoted on any of the Toronto Stock Exchange, the TSX Venture Exchange, the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market, the London Stock Exchange or any successor exchange or market thereto; or (2) the closing of a merger, amalgamation plan of arrangement or other transaction or series of related transactions resulting in the holders of Common shares receiving consideration in securities listed on a Qualified Exchange. See Note 20 – Subsequent Events.

As an inducement, the 2020 Convertible Notes holders also received 25% of the principal amount in the form of KWESST's common shares based on a stock price of \$0.45, resulting in the issuance of 600,839 common shares (see Note 17). This was accounted for as a reduction in the carrying value of the 2020 Convertible Notes.

Debt offering costs relating to the 2020 Convertible Notes were \$43,792. These are deferred and amortized over the term of the 2020 Convertible Notes. The unamortized amount is included in "Prepaid expenses and other" in the Statements of Financial Position.

12. Subscription deposits

As disclosed in Note 8, KWESST may opt to issue 557,000 common shares at a deemed value of \$278,500 (pricing at the time of the binding letter of intent to acquire) in lieu of US \$100,000 cash payment. In light of the completion of the QT during the third quarter of 2020, KWESST has elected to

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issue these shares and accordingly this was reflected in the Statements of Financial Position as at June 30, 2020. An equal amount was recognized in intangible assets.

Additionally, during the second quarter of 2020, KWESST received a subscription deposit of \$105,000 for KWESST Subscription Receipts, as defined herein (see Note 20 – Subsequent events).

13. 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.

During the first six months of 2020 and 2019, key management personnel compensation comprised the following:

	2020	2019
Wages and benefits	\$ 110,385	\$ 16,000
Consulting fees	75,000	30,000
Total	\$ 185,385	\$ 46,000

The consulting fees relate to compensation paid to KWESST's Executive Chairman (via his wholly-owned corporation, DEFSEC Corporation), including a one-time \$15,000 payment for prior year expenses in accordance with the consulting agreement.

Other key management personnel transactions

The following table summarizes the related party loans.

	Loans from directors	Employee loan	Total
Balance at December 31, 2019	\$ 229,918	\$ 59,910	\$ 289,828
Repayment of loans	(20,000)	(35,000)	(55,000)
Accrued interest	5,100	1,013	6,113
Balance at June 30, 2020	\$ 215,018	\$ 25,923	\$ 240,941

Additionally, KWESST's Executive Chairman (via his wholly-owned corporation, DEFSEC Corporation) held \$36,113 in principal amount of the 2019 Convertible Notes as at June 30, 2020 (see Note 11), on which KWESST incurred accrued interest of \$1,840 and accretion expense of \$1,206 during the first six months of 2020.

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14. Financial derivative liabilities

In connection with the issuance of the 2019 Convertible Notes (see Note 11), management determined that the conversion feature was a financial derivative liability which is remeasured at each reporting period.

The following table summarizes the financial derivative liabilities:

	Total
Balance at December 31, 2019	\$ 29,463
Fair value adjustment	177,946
Balance at June 30, 2020	\$ 207,409

15. Borrowings

To help ease the financial strain for Canadian businesses during the COVID-19 pandemic, the Canadian Federal Government offered an interest-free, government-backed loan of \$40,000 through financial institutions. If this loan is repaid by December 31, 2020, \$10,000 of the \$40,000 loan will be forgiven. During the first quarter of 2020, KWESST applied for this loan program and received \$40,000. KWESST intends to repay this loan during the fourth quarter of 2020 to take advantage of the \$10,000 forgivable amount.

16. Lease obligations

KWESST's leases are for office space and 3D printers. The office lease includes the right to renew for an additional five years. Management has not included the renewal option because it was deemed too uncertain whether the KWESST would renew at this time. At the end of the 3D printer lease, the title ownership will be transferred to KWESST.

The following table presents lease obligations for KWESST:

	June 30,	December 31,
	2020	2019
Current	\$ 7,511	\$ 85,468
Non-current	560,312	117,218
Total lease obligations	\$ 567,823	\$ 202,686

The termination relates to the former lease (see Note 7). The de-recognition of this lease obligation and the related unamortized book value of the right-of-use asset resulted in a gain of \$17,528, which is included in net finance costs in the Statements of Comprehensive Loss.

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The following table presents the contractual undiscounted cash flows for lease obligations as at June 30, 2020:

Less than one year	\$	92,976
One to five years		573,210
Total lease obligations	\$	666,186

When measuring the lease obligation, the Company discounted the remaining lease payments using the incremental borrowing rate of Company which is 10% per annum.

Interest expense on lease obligations for the six months ended June 30, 2020 was \$28,256. The total cash outflow for leases for the six months ended June 30, 2020 was \$43,089.

17. Share capital and Contributed Surplus

Share capital

Authorized

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

Issued Common Shares

	Number	Issued Price	Amount
Outstanding at December 2018	200	\$ 1.000	\$ 200
Issued for directors converted loans	6,500,000	\$ 0.005	31,308
Issued for parent company converted loans	10,700,000	\$ 0.044	467,000
Issued for directors converted loans	1,500,000	\$ 0.100	150,000
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
Outstanding at December 31, 2019	26,879,686		\$ 2,284,353
Issued in private placement	2,625,000	\$ 0.400	1,050,000
Issued in private placement	845,750	\$ 0.500	422,875
Issued for inducement bonus (see Note 11)	600,839	\$ 0.450	270,377
Issued in asset acquisition (see Note 8)	140,000	\$ 0.500	70,000
Issued in private placement	16,000	\$ 0.500	8,000
Issued for consulting services	61,000	\$ 0.531	32,392
Issued for exercise of stock options	61,000	\$ 0.500	38,690
Outstanding at June 30, 2020	31,229,275		\$ 4,176,687
Less: share offering costs			(130,707)
Total share capital at June 30, 2020			\$ 4,045,980

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Contributed Surplus

Contributed surplus consists of the cumulative amortized fair value of stock options and warrants granted since inception, less amounts transferred to share capital for exercises. If granted options and warrants expire or are forfeited, there is no reversal of contributed surplus.

Issued Stock Options

The following is summary of changes in outstanding options since December 31, 2019.

	Number of options	Weighted average exercise price
Options outstanding at December 31, 2019	-	\$ -
Granted	1,230,000	0.61
Exercised	(61,000)	0.50
Options outstanding at June 30, 2020	1,169,000	\$ 0.62
Options exercisable at June 30, 2020	475,250	\$ 0.57

The following table summarizes information about stock options outstanding at June 30, 2020:

Range of exercise prices	Number outstanding	Number exercisable	Weighted average remaining contractual life
\$0.50	244,000	244,000	0.92
\$0.65	925,000	231,250	4.67
	1,169,000	475,250	3.88

At June 30, 2020, there were 2,999,925 stock options available for grant under KWESST's stock option plan.

For the six months ended June 30, 2020, KWESST recorded stock-based compensation expenses of \$113,570 (June 30, 2019 – \$Nil). The options granted during 2020 were measured at fair value using the Black-Scholes pricing model with the following key assumptions:

	Exercise Price at \$0.50	Exercise Price at \$0.65
Stock price	\$ 0.50	\$ 0.40
Volatility	66.40%	65.46%
Dividend Yield	Nil	Nil
Risk-free interest rate	0.41%	1.07%
Expected life	1.00	5.00
Estimated fair value	\$ 0.13	\$ 0.17

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Issued Warrants

The following is a summary of changes in warrants since December 31, 2019.

	# of Warrants	Exercise Price	Fair Value	Remaining contractual life (years)
Warrants outstanding at December 31 2019	8,500,000	\$ 0.20	\$ 21,050	4.46
Issued in private placement	15,000	\$ 0.40	\$ 2,151	1.59
Issued in private placement	84,622	\$ 0.45	\$ 16,836	1.85
Issued in asset acquisition (see Note 8)	750,000	\$ 0.50	\$ 248,089	2.55
Warrants outstanding at June 30, 2020	9,349,622		\$ 288,126	

During the first six months of 2020, KWESST issued 99,622 warrants to arm's length parties in remuneration for advisory services. These warrants will expire in two years. Additionally, on June 12, 2020, KWESST issued 750,000 warrants to SageGuild LLC in connection with a technology acquisition (see Note 8), which these warrants will expire on January 15, 2013.

These warrants expire in two years and were measured at fair value using the Black-Scholes pricing model with the following key assumptions:

	Warrants @ \$0.40	Warrants @ \$0.45	Warrants @ \$0.50
Stock price	\$ 0.40	\$ 0.50	\$ 0.70
Volatility	63.94%	66.43%	66.40%
Dividend Yield	Nil	Nil	Nil
Risk-free interest rate	1.47%	0.39%	0.30%
Expected life	2	2	2
Estimated fair value	\$ 0.14	\$ 0.20	\$ 0.33

18. Financial instruments

Fair value of financial instruments

The fair values of cash, restricted cash, trade receivables and accounts payables and accrued liabilities approximate carrying value because of the short-term nature of these instruments. The carrying value of the loans payable approximate their fair value based on market rates of interest.

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.

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(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 related party loans and 2019 and 2020 Convertible Notes 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.

For the first six months of 2020, 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 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, 2020, KWESST had the following net US dollar exposure:

	Total USD
Assets	\$ 81,832
Liabilities	(7,708)
Net exposure at June 30, 2020	\$ 74,124
Impact to profit or loss if 5% movement in the US dollar	\$ 3,706

During the first six months of 2020, KWESST recorded foreign exchange loss of \$9,193, compared to foreign exchange gain of \$31,655 for the same period in 2019.

(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.

(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. While KWESST had a negative working capital of \$415,211, KWESST raised additional capital during the third quarter of 2020. Further, KWESST's 2019 and 2020 Convertible Notes were converted to KWESST's common shares on the closing of the Qualifying Transaction with Foremost (see Note 20 – Subsequent Events).

Accordingly, management believes KWESST has sufficient liquidity to meet its contractual obligations over the next 12 months.

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19. Supplemental cash flow information

The following is a summary of non-cash items that were excluded from the Statements of Cash Flows for the six months ended June 30, 2020:

- \$554,069 of right-of-use asset and lease obligations relating to the new office lease;
- \$139,787 of right-of-use asset and \$157,316 lease obligations de-recognized from KWESST's Statements of Financial Position relating to the former lease office;
- \$596,589 non-cash component (share settlement) of the total purchase consideration relating to the asset acquisition of GhostStep® Technology;
- \$33,530 of deferred offering costs settled in shares;
- \$270,377 share issuance as "bonus shares" to the 2020 Convertible Notes holders;
- \$16,836 of share offering costs settled in common shares; and
- \$8,190 fair value of options exercised and transferred to share capital.

20. Subsequent Events

Reverse Takeover and KWESST Financing

On September 17, 2020, Foremost completed its Qualifying Transaction ("QT") with KWESST pursuant to the policies of the TSX-Venture Exchange ("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 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 (the "KWESST Shares") were cancelled and, in consideration therefor, 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.

On September 22, 2020, the KWESST Micro System Inc. shares began trading on the TSX-V under the stock symbol KWE.

As part of the QT, the subscription receipts issued by KWESST 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.

Immediately following the QT, there were 41,266,821 shares of KWESST outstanding, of which 40,367,678 were held by the former shareholders of KWESST (representing approximately 97.8% of the outstanding shares of the Company) and 899,143 were held by the shareholders of Foremost prior to the QT. Accordingly, this transaction will be accounted for as a reverse takeover where KWESST is the acquirer.

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Conversion of the 2019 and 2020 Convertible Notes

As a result of the QT, KWESST all outstanding 2019 and 2020 Convertible Notes - including accrued interest thereon - were automatically converted into common shares of KWESST, resulting in the issuance of 456,639 and 2,609,213 common shares to the 2019 Convertible Notes and 2020 Convertible Notes holders, respectively.