



Consolidated Financial Statements of

KWESST MICRO SYSTEMS INC.

Years ended September 30, 2023, 2022, and 2021

(Expressed in Canadian Dollars)

KWESST MICRO SYSTEMS INC.

Table of contents for the years ended September 30, 2023, 2022, and 2021

	Page
Independent Auditor's Report	1
FINANCIAL STATEMENTS	
Consolidated Statements of Financial Position	2
Consolidated Statements of Net Loss and Comprehensive Loss	3
Consolidated Statements of Changes in Shareholders' Equity (Deficit)	4
Consolidated Statements of Cash Flows	5
Notes to the Consolidated Financial Statements	6-53

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of

KWESST Micro Systems Inc.

Opinion

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors

KWESST Micro Systems Inc.:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated statements of financial position of KWESST Micro Systems Inc. (the Company) as of September 30, 2023 and 2022, the related consolidated statements of net loss and comprehensive loss, shareholders' equity (deficit), and cash flows for each of the years in the two-year period ended September 30, 2023, and the related notes (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of September 30, 2023 and 2022, and its financial performances and its cash flows for each of the years in the two-year period ended September 30, 2023, in conformity with International Financial Reporting Standards as issued by the International Accounting Standard Board.

Going Concern

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

Basis for Opinion

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

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits, we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audit provides a reasonable basis for our opinion.

/s/ KPMG LLP

Chartered Professional Accountants, Licensed Public Accountants

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

Ottawa, ON

January 17, 2024

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Financial Position
At September 30, 2023 and 2022

<i>In Canadian dollars</i>	Notes	September 30, 2023	September 30, 2022
ASSETS			
Cash and cash equivalents		\$ 5,407,009	\$ 170,545
Restricted short-term investment	12	30,000	30,000
Trade and other receivables	5	300,269	171,882
Inventories	6	542,388	393,538
Prepaid expenses and other		562,408	122,166
Deferred share offering costs		-	628,262
Current assets		6,842,074	1,516,393
Property and equipment	7	417,296	832,481
Right-of-use assets	8	361,036	208,131
Deposit	8	26,076	23,604
Intangible assets	9	4,112,350	4,742,854
Non-current assets		4,916,758	5,807,070
Total Assets		\$ 11,758,832	\$ 7,323,463
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Accounts payable and accrued liabilities	10	\$ 1,649,876	\$ 4,459,481
Accrued royalties liability	4(b)	150,000	150,000
Lease obligations	13	127,116	69,150
Borrowings	12	-	2,199,978
Contract liabilities	14	120,970	47,271
Warrant liabilities	15	4,335,673	-
Current liabilities		6,383,635	6,925,880
Accrued royalties liability	4(b)	1,137,170	1,115,207
Lease obligations	13	302,407	206,471
Borrowings	12	-	78,796
Non-current liabilities		1,439,577	1,400,474
Total Liabilities		7,823,212	8,326,354
Shareholders' Equity (Deficit)			
Share capital	16(a)	33,379,110	19,496,640
Warrants	16(b)	1,042,657	1,959,796
Contributed surplus	16(c)	4,769,115	3,551,330
Accumulated other comprehensive loss		(39,663)	(101,418)
Accumulated deficit		(35,215,599)	(25,909,239)
Total Shareholders' Equity (Deficit)		3,935,620	(1,002,891)
Total Liabilities and Shareholders' Equity (Deficit)		\$ 11,758,832	\$ 7,323,463

See Note 2(a) Going concern and Note 27 Commitments and contingencies.

See accompanying notes to the consolidated financial statements.

On behalf of the Board of Directors:

(signed) Paul Mangano, Director

(signed) David Luxton, Director

KWESST MICRO SYSTEMS INC.

Consolidated Statements of Net Loss and Comprehensive Loss

Years ended September 30, 2023, 2022 and 2021

	September 30, 2023	September 30, 2022	September 30, 2021
<i>In Canadian dollars</i>			
Revenue	\$ 1,234,450	\$ 721,519	\$ 1,275,804
Cost of sales	(1,425,828)	(536,735)	(798,888)
Gross profit	(191,378)	184,784	476,916
Operating expenses			
General and administrative	7,244,762	4,915,263	4,057,167
Selling and marketing	3,024,283	3,296,373	3,484,159
Research and development, net	1,644,565	2,064,493	2,138,138
Total operating expenses	11,913,610	10,276,129	9,679,464
Operating loss	(12,104,988)	(10,091,345)	(9,202,548)
Other income (expenses)			
Share issuance costs	(1,985,074)	-	-
Net finance costs	(668,034)	(506,002)	(107,751)
Foreign exchange gain (loss)	(98,275)	28,780	(3,742)
Change in fair value of warrant liabilities	5,841,192	-	-
Loss on disposal of property and equipment	(291,181)	(1,165)	(1,331)
Total other income (expenses), net	2,798,628	(478,387)	(112,824)
Loss before income taxes	(9,306,360)	(10,569,732)	(9,315,372)
Income tax recovery			
Deferred tax recovery	-	49,442	-
Net loss	\$ (9,306,360)	\$ (10,520,290)	\$ (9,315,372)
Other comprehensive income:			
<i>Items that are or may be reclassified subsequently to profit or loss:</i>			
Foreign currency translation differences	61,755	(92,427)	(8,991)
Total comprehensive loss	\$ (9,244,605)	\$ (10,612,717)	\$ (9,324,363)
Net loss per share			
Basic and diluted	\$ (2.28)	\$ (14.41)	\$ (14.72)
Weighted average number of shares outstanding			
Basic and diluted	4,082,275	730,302	632,721

See accompanying notes to the consolidated financial statements.

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Changes in Shareholders' Equity (Deficit)
Years ended September 30, 2023, 2022 and 2021
In Canadian dollars

			Contingent		Contributed	Translation		Total
	Notes	Share capital	shares	Warrants	surplus	reserve	Deficit	Shareholders' Equity (Deficit)
Balance, September 30, 2020		9,374,563	-	277,170	306,708	-	(6,073,577)	3,884,864
Shares issued for debt	16(a)	63,866	-	-	-	-	-	63,866
Warrants exercised	16(b)	815,307	-	(175,741)	-	-	-	639,566
Shares and warrants issued on asset acquisition	4(b)	1,290,000	-	425,000	-	-	-	1,715,000
Shares for amended license		137,000	-	-	-	-	-	137,000
Shares and warrants issued for cash	16(a),(b)	4,721,818	-	1,280,654	-	-	-	6,002,472
Stock options and warrants exercised	16(c)	1,639,695	-	41,306	(531,263)	-	-	1,149,738
Share-based compensation	16(c)	-	-	-	2,462,207	-	-	2,462,207
Restricted share units vested	16(c)	12,498	-	-	(12,498)	-	-	-
Share offering costs	16(a)	- 839,679	-	-	233,057	-	-	(606,622)
Other comprehensive loss		-	-	-	-	(8,991)	-	(8,991)
Net loss		-	-	-	-	-	(9,315,372)	(9,315,372)
Balance, September 30, 2021		\$ 17,215,068	\$ -	\$ 1,848,389	\$ 2,458,211	\$ (8,991)	\$ (15,388,949)	\$ 6,123,728
Shares issued for debt	16(a)	19,000	-	-	-	-	-	19,000
Shares and warrants issued on acquisition	4(a)	377,503	83,319	132,000	-	-	-	592,822
Shares and warrants issued for cash	16(a),(b)	272,000	-	72,000	-	-	-	344,000
Contingent shares converted to common shares	4(a)	83,319	(83,319)	-	-	-	-	-
Warrants exercised	16(b)	277,098	-	(61,173)	-	-	-	215,925
Warrants expired	16(b)	-	-	(31,420)	31,420	-	-	-
Share-based compensation	16(c)	-	-	-	1,960,072	-	-	1,960,072
Shares for vested RSUs and PSUs	16(c)	874,840	-	-	(874,840)	-	-	-
Vested RSUs and PSUs repurchased for	16(c)	-	-	-	(23,533)	-	-	(23,533)
Shares issued for unsecured loans	12	411,692	-	-	-	-	-	411,692
Share offering costs	16(a)	(33,880)	-	-	-	-	-	(33,880)
Other comprehensive loss		-	-	-	-	(92,427)	-	(92,427)
Net loss		-	-	-	-	-	(10,520,290)	(10,520,290)
Balance, September 30, 2022		\$ 19,496,640	\$ -	\$ 1,959,796	\$ 3,551,330	\$ (101,418)	\$ (25,909,239)	\$ (1,002,891)
Shares issued for public offering	16(a)	16,725,436	-	-	-	-	-	16,725,436
Share offering costs	16(a)	(3,671,791)	-	393,911	125,086	-	-	(3,152,794)
Shares issued for debt	16(a)	233,485	-	-	-	-	-	233,485
Options exercised	16(c)	5,836	-	-	(1,789)	-	-	4,047
Warrants exercised	16(b)	60,000	-	(60,000)	-	-	-	-
Warrants expired	16(b)	-	-	(1,251,050)	1,251,050	-	-	-
Share-based compensation	16(c)	-	-	-	373,554	-	-	373,554
Shares for vested RSUs and PSUs	16(c)	529,504	-	-	(529,504)	-	-	-
Vested RSUs and PSUs repurchased for withholding taxes		-	-	-	612	-	-	612
Other comprehensive income		-	-	-	-	61,755	-	61,755
Net loss		-	-	-	-	-	(9,306,360)	(9,306,360)
Balance, September 30, 2023		\$ 33,379,110	\$ -	\$ 1,042,657	\$ 4,769,115	\$ (39,663)	\$ (35,215,599)	\$ 3,935,620

See accompanying notes to the consolidated financial statements.

KWESST MICRO SYSTEMS INC.
Consolidated Statements of Cash Flows
Years ended September 30, 2023, 2022 and 2021

<i>In Canadian dollars</i>	Notes	September 30, 2023	September 30, 2022	September 30, 2021
OPERATING ACTIVITIES				
Net loss		\$ (9,306,360)	\$ (10,520,290)	\$ (9,315,372)
<i>Items not affecting cash:</i>				
Depreciation and amortization	7, 8, 9 and 20	952,508	326,491	140,990
Share-based compensation	16(c)	373,554	1,960,072	2,462,207
Change in fair value of warrant liabilities (including related foreign exchange gain)	15	(5,786,593)	-	-
Net finance costs	21	668,033	506,002	107,751
Impairment of intangible assets	9	1,169,440	-	55,376
Loss on disposals		291,181	1,165	1,331
Shares for amended licence		-	-	137,000
Deferred tax recovery	22	-	(49,442)	-
Changes in non-cash working capital items	24	(2,310,266)	3,639,822	198,484
Interest paid		(130,126)	(120,416)	(42,980)
Cash used in operating activities		(14,078,629)	(4,256,596)	(6,255,213)
INVESTING ACTIVITIES				
Additions of property and equipment	7	(176,949)	(187,478)	(809,964)
Investments in intangible assets	9	(1,123,186)	(1,176,664)	(83,228)
Deposit for advanced royalties	4(b)	(148,410)	-	(150,000)
Purchase of restricted short-term investment	12	-	-	(30,000)
Recognition of open orders from acquisition	9	7,811	87,802	-
Cash acquired on acquisition	4	-	162,547	-
Cash flows used in investing activities		(1,440,734)	(1,113,793)	(1,073,192)
FINANCING ACTIVITIES				
Proceeds from U.S. IPO and Canadian Offering, net	16(a)	16,346,768	-	-
Proceeds from the issuance of common shares and warrants	16(a)	7,357,012	344,000	6,002,472
Payments of share offering costs	16(a)	(542,591)	(33,880)	(606,622)
Proceeds from borrowings	12	-	2,543,230	326,000
Payments of deferred financing fees	12	-	(150,409)	-
Repayment of borrowings	12	(2,333,315)	-	(306,000)
Repayments of lease obligations	13	(75,487)	(42,504)	(44,128)
Proceeds from related party advances	11	-	60,000	-
Repayments to related party advances	11	-	(60,000)	(218,276)
Proceeds from exercise of warrants	16(b)	-	215,925	680,872
Proceeds from exercise of stock options	16(c)	4,052	-	1,108,432
Repurchase of vested RSUs and PSUs for withholding taxes		(612)	(23,533)	-
Cash flows provided by financing activities		20,755,827	2,852,829	6,942,750
Net change in cash during the period		5,236,464	(2,517,560)	(385,655)
Cash, beginning of period		170,545	2,688,105	3,073,760
Cash, end of period		\$ 5,407,009	\$ 170,545	\$ 2,688,105
Cash and cash equivalents consist of the following:				
Cash held in banks		4,407,009	170,545	2,688,105
Short-term guaranteed investment certificates		1,000,000	-	-
Cash and cash equivalents, end of period		5,407,009	170,545	2,688,105

See Note 24 Supplemental cash flow information.

See accompanying notes to the consolidated financial statements.

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

1. Corporate information

a) Corporate information

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

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

KWESST’s common stock is listed on the TSX-Venture Exchange (“TSX-V”) under the stock symbol of KWE, on the Nasdaq Capital Market (“Nasdaq”) under the stock symbol of KWE and on the Frankfurt Stock Exchange under the stock symbol of 62U. Additionally, warrants issued in the United States are also listed on the Nasdaq under the stock symbol of KWESW. Effective May 1, 2023, the warrants issued in Canada are listed on the TSX-V under the stock symbol of KWE.WT.U.

b) Reverse Stock Split

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

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

2. Basis of preparation

(a) *Going concern*

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

As an early-stage company, we have not yet reached commercial production for most of our products and have incurred significant losses and negative operating cash flows from inception that have primarily been funded from financing activities. We have incurred a \$9.3 million net loss and negative operating cash flows of approximately \$14.1 million for the year ended September 30, 2023 (2022 - \$10.5 million net loss and negative operating cash flows of \$4.3 million, 2021 - \$9.3 million net loss and negative operating cash flows of \$6.3

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

million). At September 30, 2023, we had \$0.5 million in positive working capital (2022 – negative working capital of \$5.4 million, 2021 – positive working capital of \$2.9 million).

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

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

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

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

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

(b) Statement of compliance

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

The consolidated financial statements were authorized for issue by the Board of Directors effective on January 17, 2024.

(c) Basis of consolidation

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

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

At September 30, 2023, we have the following wholly owned subsidiaries:

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

(d) Functional and presentation currency

The consolidated financial statements are presented in Canadian dollars ("CAD"), our functional and presentation currency.

(e) Basis of measurement

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

(f) Use of estimates and judgments

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

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

Judgments

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

- Note 4(a) - *acquisition of Police Ordnance*: whether the consideration transferred, and purchase price allocation assumptions used as inputs in determining the fair value of net assets acquired is reasonable;
- Note 4(b) - *acquisition of PARA OPSTM System*: whether the estimated discount rate used to discount the minimum royalty payments is reasonable, and the reasonability of the volatility assumption used in the Black Scholes option model to estimate the fair value of the warrants issued to DEFSEC;
- Note 12 – *unsecured loans*: whether the estimated market discount rate used to estimate the fair value of the unsecured loans is reasonable;
- Note 15 – *warrant liabilities*: whether the valuation and the volatility assumptions used in the Black Scholes calculations for the warrant liabilities are reasonable;

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

- Note 16(c) - *share-based compensation*: whether the determination of KWESST's stock volatility, forfeiture rate, and expected life are reasonable in light of its limited operating history, all significant inputs in the valuation model to fair value options granted; and
- Note 16(c) - *broker compensation options*: whether the Monte Carlo valuation model and number of simulations, coupled with the volatility assumption, are reasonable to estimate the fair value of these options.

Estimates

Information about assumptions and estimation uncertainties at September 30, 2023, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next financial year is included in the following notes:

- Note 9 - *impairment test of intangible assets*: key assumptions underlying recoverable amounts, including current and future market conditions, timing of commercialization, revenue and costs as well as market value inputs; and
- Note 18 – *Revenue*: key assumptions underlying the recognition of revenue based on percentage of completion, including remaining hours to complete.

3. Significant accounting policies

(a) Revenue recognition

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

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

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

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

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

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

(b) Business combinations

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

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

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

(c) Financial instruments

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

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

Financial assets

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

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

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

A financial asset is measured at amortized cost if it is held within a business model whose objective is to hold assets to collect contractual cash flows, and its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest of the principal amount outstanding. Financial assets classified at amortized cost are measured using the effective interest method. At September 30, 2023, we classified the following as amortized cost:

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

All financial assets not classified and measured at amortized cost or FVOCI are measured at FVTPL. At September 30, 2023, we did not have financial assets classified as FVOCI or FVTPL.

Expected credit losses

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

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

Financial liabilities

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

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

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

The warrant liabilities are classified as FVTPL.

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

De-recognition of financial liabilities

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

(d) Cash and cash equivalents

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

(e) Inventories

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

(f) Property and equipment

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

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

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

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

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

(g) Leases

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

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

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

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

(h) Intangible assets

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

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

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

(ii) Subsequent expenditure

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

(iii) Acquired intangible assets

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

(iv) Amortization

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

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

(v) Impairment

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

(i) Provisions

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

(j) Income taxes

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

Current income tax

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

Deferred income tax

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

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

Investment tax credits

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

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

(k) Related party transactions

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

(l) Share-based compensation

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

Equity-settled service award

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

Equity-settled performance award

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

Modified award

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

(m) Foreign currency

Foreign currency transactions

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

Foreign operations

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

(n) Earnings (loss) per share

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

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

4. Acquisitions

a) Police Ordnance

On December 15, 2021, we acquired 2720178 Ontario Inc., an Ontario (Canada) corporation, which owns all of the issued and outstanding shares of Police Ordnance Company Inc., an Ontario (Canada) corporation (together, "Police Ordnance"), herein referred as the "Police Ordnance Acquisition". Located in Bowmanville, Ontario, with ancillary operations in Florida, Police Ordnance owns all intellectual properties to the ARWENTM product

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

line of launchers, and a proprietary line of 37 mm cartridges designed for riot control and tactical teams. Police Ordnance has law enforcement customers across Canada, the United States, and abroad. The Police Ordnance Acquisition provides us with a strategic opportunity to leverage its law enforcement customer base to accelerate growth within its specialty ordnance business.

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

Consideration Transferred:

The purchase consideration comprised of the following:

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

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

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

We have estimated the fair value as follows:

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

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

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

Net Assets Acquired:

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

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

Impact on KWESST's Results of Operations:

The results of operations of Police Ordinance are included in these consolidated statements of net loss and comprehensive loss from December 16, 2021. For the year ended September 30, 2023, Police Ordinance contributed revenue of \$375,758 and net loss of \$505,733 to our consolidated results.

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

We incurred immaterial acquisition-related costs.

b) LEC System

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

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

As DEFSEC is a private company owned by our Executive Chairman, this asset acquisition is a related party transaction. We relied on exemptions from the formal valuation and minority shareholder approval requirements available under Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions*. However, we obtained approval from over 51% disinterested shareholders as well as from the TSX-V prior to closing the acquisition.

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

The purchase consideration consisted of:

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

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

The minimum annual royalty payments are as follows:

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

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

The purchase price was determined as follows:

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

We estimated the fair value as follows:

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

During the year ended September 30, 2023, we recorded \$170,373 of accretion cost relating to the discounted minimum royalty payments, which is included in net finance costs in the consolidated statements of net loss and comprehensive loss (2022 - \$159,451, 2021 - \$64,537). As at September 30, 2023, \$1,287,170 of accrued royalties liability was outstanding (2022 - \$1,265,207, 2021 - \$1,105,756).

5. Trade and other receivables

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

	September 30, 2023	September 30, 2022
Trade receivables	\$ 68,530	\$ 114,877
Unbilled revenue	5,211	8,881
Sales tax recoverable	226,528	48,124
Other receivable	-	-
Total	\$ 300,269	\$ 171,882

There was no impairment of trade and other receivables during the year ended September 30, 2023 (2022 – \$nil).

The following table presents changes in unbilled receivables:

	September 30, 2023	September 30, 2022
Balance, beginning of period	\$ 8,881	\$ 308,728
Revenue billed during the period	(3,670)	(308,728)
Revenue in excess of billings, net of amounts transferred to trade receivables	-	8,881
Balance, end of period	\$ 5,211	\$ 8,881
Current	\$ 5,211	\$ 8,881
Non-current	\$ -	\$ -

6. Inventories

The following table presents a breakdown of our inventories:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	September 30, 2023	September 30, 2022
Finished goods	\$ 62,730	\$ 49,643
Work-in-progress	116,435	21,350
Raw materials	363,223	322,545
Total	\$ 542,388	\$ 393,538

There was no impairment of inventories during the year ended September 30, 2023 (2022 – \$nil, 2021 – \$nil).

7. Property and equipment

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

Cost	Computer equipment	Computer software	Office furniture and equipment	LRIP equipment ⁽¹⁾	R&D equipment	Leasehold improvements	Sales demo equipment	Total
Balance at September 30, 2021	\$ 59,757	\$ -	\$ 90,116	\$ -	\$ 217,940	\$ 117,237	\$ 548,626	\$ 1,033,676
Additions	50,849	5,129	10,817	77,559	21,864	19,800	1,460	187,478
Disposals	(3,800)	-	-	-	-	-	-	(3,800)
Balance at September 30, 2022	\$ 106,806	\$ 5,129	\$ 100,933	\$ 77,559	\$ 239,804	\$ 137,037	\$ 550,086	\$ 1,217,354
Additions	37,047	-	8,645	20,099	-	2,680	108,478	176,949
Disposals	-	-	-	-	-	(7,925)	(549,330)	(557,255)
Balance at September 30, 2023	\$ 143,853	\$ 5,129	\$ 109,578	\$ 97,658	\$ 239,804	\$ 131,792	\$ 109,234	\$ 837,048

Accumulated depreciation	Computer equipment	Computer software	Office furniture and equipment	Moulding equipment	R&D equipment	Leasehold improvements	Sales demo equipment	Total
Balance at September 30, 2021	\$ 18,398	\$ -	\$ 40,364	\$ -	\$ 38,287	\$ 16,534	\$ 16,444	\$ 130,027
Depreciation	26,762	1,254	19,067	7,002	46,219	27,915	129,262	257,481
Disposals	(2,635)	-	-	-	-	-	-	(2,635)
Balance at September 30, 2022	\$ 42,525	\$ 1,254	\$ 59,431	\$ 7,002	\$ 84,506	\$ 44,449	\$ 145,706	\$ 384,873
Depreciation	34,937	1,710	20,753	18,749	50,618	21,141	153,045	300,953
Disposals	-	-	-	-	-	(7,925)	(258,149)	(266,074)
Balance at September 30, 2023	\$ 77,462	\$ 2,964	\$ 80,184	\$ 25,751	\$ 135,124	\$ 57,665	\$ 40,602	\$ 419,752

Carrying value at September 30, 2022	\$ 64,281	\$ 3,875	\$ 41,502	\$ 70,557	\$ 155,298	\$ 92,588	\$ 404,380	\$ 832,481
Carrying value at September 30, 2023	\$ 66,391	\$ 2,165	\$ 29,394	\$ 71,907	\$ 104,680	\$ 74,127	\$ 68,632	\$ 417,296

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

8. Right-of-use assets

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

	Offices
Balance at September 30, 2021	\$ 266,214
Depreciation	(58,083)
Balance at September 30, 2022	\$ 208,131
Additions	228,020
Depreciation	(75,115)
Balance at September 30, 2023	\$ 361,036

In connection with our current lease, we made a total deposit of \$33,726 to be released only at the end of this lease. This was initially recorded at fair value, discounted using the implied interest rate in the lease. At

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

September 30, 2023, \$26,076 (2022 - \$23,604, 2021 - \$21,367) was the carrying value and reported as non-current deposit in the consolidated statements of financial position.

9. Intangible assets

The following table shows a breakdown of our intangible assets:

	KWE Inc	KWE PSSC	KWE PSSC	POC	POC	POC	
					Customer		
Cost	Phantom™ System	PARA OPS™ System	PARA OPS™ Patent	ARWEN™ Tradename	Relationship s	Purchase Orders	Total
Balance at September 30, 2021	\$ 564,700	\$ 2,906,219	\$ -	\$ -	\$ -	\$ -	\$ 3,470,919
Additions	584,885	562,996	28,783	-	-	-	1,176,664
Acquisition	-	-	-	44,000	50,000	100,000	194,000
Amortization	-	-	-	(6,968)	(3,959)	-	(10,927)
Recognition of open orders	-	-	-	-	-	(87,802)	(87,802)
Balance at September 30, 2022	\$ 1,149,585	\$ 3,469,215	\$ 28,783	\$ 37,032	\$ 46,041	\$ 12,198	\$ 4,742,854
Additions	19,855	1,091,819	11,512	-	-	-	1,123,186
Impairment charge	(1,169,440)	-	-	-	-	-	(1,169,440)
Amortization	-	(562,640)	-	(8,800)	(5,000)	-	(576,440)
Recognition of open orders	-	-	-	-	-	(7,811)	(7,811)
Balance at September 30, 2023	\$ -	\$ 3,998,394	\$ 40,295	\$ 28,232	\$ 41,041	\$ 4,387	\$ 4,112,350

The balance at September 30, 2023 for PARA OPS™ represents the acquired technology asset (i.e. intellectual properties), coupled with additional capitalized development costs. As it is available for its intended use, amortization charge was recorded for the year ended September 30, 2023 of \$562,240 (2022 - \$nil, 2021 - \$nil).

ParaOps was tested for impairment at September 30, 2023. The key assumptions used in determining the recoverable amount were that commercialization would be reached by the second half of 2024 and that market penetration would be achieved at prices that would be accepted by the market place. If commercialization is not achieved or is not achieved on a timely basis or market acceptance and penetration is not inline with expectations then this would result in an impairment. The recoverable amount was determined based on value in use based on cash flows over a period of five years.

During the fourth quarter of 2023, the Company determined that the Phantom System was impaired and the asset was written off. The required investment to advance the system to commercialization is considered to be too high and the technology is no longer viable for the Company's operations. The carrying amount of the Phantom System at the beginning of the fiscal year was \$1,149,585 and additions of \$19,855 were made in the fiscal year. The entire carrying amount of \$1,169,440 was written off as an impairment to intangible assets included in the general and administrative expenses in the Consolidated Statement of Net Loss and Comprehensive Loss. This has resulted in an expense in the consolidated statement of net loss.

In connection with Police Ordnance Acquisition (see Note 4(a)), we have recorded the following intangible assets at fair value: ARWEN™ tradename, customer relationships and open purchase orders. During the year ended September 30, 2023, we have delivered on most open purchase orders resulting in a decrease of \$7,811 (2022 - \$87,802). Management has estimated the useful lives of tradename and customer relationships of five and ten years, respectively.

10. Accounts payable and accrued liabilities

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	September 30, 2023	September 30, 2022
Trade payable	\$ 367,128	\$ 2,292,954
Accrued liabilities	1,189,678	1,045,409
Salary and vacation payable	93,070	1,116,203
Interest payable	-	4,915
Total	\$ 1,649,876	\$ 4,459,481

11. Related party transactions

Key management personnel compensation

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

Key management personnel compensation comprised the following:

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
Wages and benefits	\$ 505,026	\$ 641,338	\$ 427,252
Consulting fees	628,264	529,529	180,000
Directors compensation	130,000	70,000	85,000
Share-based compensation	167,027	860,400	988,716
Total	\$ 1,430,317	\$ 2,101,267	\$ 1,680,968

The consulting fees relate to compensation to our Executive Chairman (via his private corporation, DEFSEC Corp), as well as compensation to our previous Vice President who was an employee prior to fiscal year 2023 and was included in wages and benefits for fiscal year 2022. Fiscal year 2022 also included a bonus to the Executive Chairman, which was approved by our Board of Directors and paid only after the U.S. IPO and Canadian Offering. Consulting fees also includes fees payable to an independent director for advisory services relating to PARA OPS™.

Other related party transactions:

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

At September 30, 2023 there was \$216,730 (2022 - \$672,531) outstanding amount in accounts payable and accrued liabilities due to our officers and directors for unpaid wages, bonuses, director fees and expense reimbursements.

12. Borrowings

	CEBA Term Loans	March 2022 Loans	August 2022 Loans	Total Borrowings
Balance, September 30, 2021	\$ 53,251	\$ -	\$ -	\$ 53,251
Assumed from acquisition (Note 4)	26,238	-	-	26,238
Issuance at fair value	-	1,634,283	475,591	2,109,874
Deferred financing fees	-	(74,055)	(76,354)	(150,409)
Net borrowings	79,489	1,560,228	399,237	2,038,954
Adjustment	(5,496)	-	-	(5,496)
Accrued interest and accretion expense	4,803	304,922	11,588	321,313
Foreign exchange loss	-	-	24,523	24,523
Interest paid	-	(100,520)	-	(100,520)
Balance, September 30, 2022	\$ 78,796	\$ 1,764,630	\$ 435,348	\$ 2,278,774
Accrued interest and accretion expense	11,204	274,887	179,096	465,187
Interest paid	-	(39,517)	(63,661)	(103,178)
Repayment of principal	(70,000)	(1,988,000)	(275,315)	(2,333,315)
Settled in equity (Notes 12 and 18)	-	(12,000)	(275,468)	(287,468)
Forgivable amount	(20,000)	-	-	(20,000)
Balance, September 30, 2023	\$ -	\$ -	\$ -	\$ -

August 2022 Loans

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

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

As a result of issuing common shares and debt for the first loan of USD\$200,000 (or \$260,698), in Fiscal 2022 we allocated the gross proceeds to these two financial instruments based on their relative fair value. To measure the fair value of the loan, we used the income approach and estimated a market discount rate of 24% to discount the future cash flows of the loan resulting in an estimated fair value of \$214,893. Accordingly, we allocated \$214,893 of the \$260,698 to the first loan and \$45,804 to share capital for the bonus common shares issued (see Note 16(a)).

Concurrently with the closing of the August 2022 Loans, our Executive Chairman and President and Chief Executive Officer (the "KWESST Principals") entered into call option agreements with the Lender whereby the Lender will have the option, pursuant to the terms and conditions of the call option agreements, to purchase 10,591 common shares held by the KWESST Principals at a price of \$12.25 for a period of five years. Additional

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

free-trading common shares may be offered by the KWESST Principals to the Lender should we elect to proceed with a share-for-debt transaction in connection with one of the Loans. KWESST is not a party to the call option agreements.

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

March 2022 Loans

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

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

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

CEBA Term Loans

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

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

Effective January 1, 2021, the CEBA Term Loans were automatically converted to a 2-year interest free term loan. This was further amended on January 12, 2022, where the government of Canada announced the repayment deadline for the CEBA Term Loans to qualify for partial loan forgiveness is being extended from December 31, 2022, to December 31, 2023, for all eligible borrowers in good standing. Repayment on or before the new deadline of December 31, 2023, will result in loan forgiveness of up to a third of the loans.

Loan Repayments

In December 2022, the Company repaid the remaining balance on the March 2022, August 2022, and CEBA Term Loans, including accrued unpaid interest, net of the total forgivable amount on the CEBA Term loan of \$20,000 and a 10% premium on the August 2022 loan. The loans were repaid with a combination of cash and equity.

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

RBC Credit Facility

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

13. Lease obligation

We have entered into a long-term office lease contracts which expire on April 30, 2026, May 31, 2026, and October 31, 2026. The office leases include the right to renew for an additional term following its expiry. Management has not included the renewal option because it was deemed too uncertain whether we would renew at September 30, 2023.

Under the current office lease agreements, we have benefited from the following lease inducements:

- Free rent from inception (March 1, 2020) to November 1, 2020;
- Free rent from November 1, 2021, to March 1, 2022; and
- Free rent from August 1, 2023, to October 31, 2023.

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

		Offices	Current Portion	Non-current portion
Balance at September 30, 2021	\$	307,909	\$ 32,288	\$ 275,621
Lease payments (including interest)		(62,400)	-	-
Interest expense		30,112	-	-
Balance at September 30, 2022	\$	275,621	\$ 69,150	\$ 206,471
Additions		228,020	-	-
Lease payments (including interest)		(111,903)	-	-
Interest expense		37,785	-	-
Balance at September 30, 2023	\$	429,523	\$ 127,116	\$ 302,407

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

	September 30, 2023	September 30, 2022
Less than one year	\$ 197,367	\$ 93,600
One to five years	361,388	234,000
Total	\$ 558,755	\$ 327,600

14. Contract Liabilities

The following table presents the changes in contract liabilities:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	September 30, 2023	September 30, 2022
Balance, beginning of fiscal year	\$ 47,271	\$ -
Acquired in acquisition of POC (see Note 4(a))	-	29,759
Amounts invoiced and revenue deferred	120,970	17,512
Recognition of deferred revenue included in the balance at the beginning of period	(47,271)	-
Balance, end of fiscal year	\$ 120,970	\$ 47,271

15. Warrant liabilities

The following is a reconciliation of warrant liabilities since September 30, 2022:

	U.S. IPO and Canadian Offering			Private Placement		Debt Settlement	
	Over-allotment						
	2022 Warrants	Pre-Funded Warrants	Over-allotment Warrants	2023 Warrants	Pre-Funded Warrants	Warrants	Total
Balance, beginning of period	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Initial recognition	4,617,451	832,698	536,681	1,528,160	2,778,534	80,617	10,374,141
(Gain) Loss on revaluation of financial instruments	(3,553,175)	(415,996)	(412,247)	(765,212)	(883,961)	(62,476)	(6,093,067)
Exchange gain on revaluation	(21,738)	(2,368)	(3,261)	35,625	46,341	-	54,599
Balance, end of period	\$ 1,042,538	\$ 414,334	\$ 121,173	\$ 798,573	\$ 1,940,914	\$ 18,141	\$ 4,335,673
Number of outstanding securities as at September 30, 2023	3,226,392	199,000	375,000	1,542,194	930,548	56,141	6,329,275

U.S. IPO and Canadian Offering

On December 9, 2022, we closed the U.S. IPO and the Canadian Offering. In the U.S. IPO, we sold 2.5 million units, consisting of one share of common share and one warrant to purchase one common share. In connection with the closing of the U.S. IPO, the underwriter partially exercised its over-allotment option to purchase an additional 199,000 pre-funded common share purchase warrants and 375,000 option warrants. In the Canadian Offering, we sold 726,392 units, each consisting of one common share and one warrant to purchase one common share (see Note 16(a)). In summary, for the U.S. IPO and the Canadian Offering, we have issued 3,226,392 warrants (the “2022 Warrants”) with an exercise price of US\$5.00 per share. Additionally, the U.S. underwriter exercised its over-allotment option to purchase:

- 199,000 Pre-Funded Warrants with an exercise price of US\$0.01 per share for \$3.81024 per pre-funded warrant (net of underwriter discount); and
- 375,000 warrants with exercise price of US\$5.00 per share for \$0.0001 per warrant.

Refer to Note 16(a) for further information on the U.S. IPO and Canadian Offering.

Under IFRS, the above securities are classified as financial liabilities (referred herein as “warrant liabilities”) because the exercise price is denominated in U.S. dollars, which is different to our functional currency (Canadian dollars). Accordingly, the ultimate proceeds in Canadian dollars from the potential exercise of the above securities are not known at inception. These financial liabilities are classified and measured at FVTPL (see Note 3(c)). Gains on revaluation of the warrant liabilities are presented in other income (expenses) on the consolidated statements of net loss and comprehensive loss.

Warrant liabilities

While the warrants issued in the U.S. IPO were listed on Nasdaq and closed at US\$0.90 per warrant on December 9, 2022, management concluded that this closing price was not reflective of an active market due to short trading window and therefore not representative of fair value. Accordingly, at inception, the 2022 Warrants were measured at fair value using the Black Scholes option pricing model (Level 2). We used the following assumptions:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	2022	Over-allotment	
	Warrants ⁽¹⁾	Pre-Funded Warrants ⁽²⁾	Over-allotment Warrants ⁽³⁾
Number of dilutive securities	3,282,533	199,000	375,000
Exercise price (in USD)	\$ 5.00	\$ 0.01	
Share price (in USD)	\$ 4.13	\$ 3.08	
Expected life	2.50		
Dividend	\$ -		
Volatility	75%		
Risk free rate	4.20%		
Exchange rate (USD/CAD)	\$ 1.363		
Fair value per warrant (CAD)	\$ 1.43	\$ 4.18	\$ 1.43

(1) Includes debt settlement warrants

(2) Fair value is measured at the underlying common share closing price on Nasdaq on December 9, 2022, less US\$0.01 exercise price.

(3) Same fair value as calculated for Warrants.

The share price (in USD) for the over-allotment pre-funded warrants was based on the estimated fair value of the common shares issued on December 9, 2022, by deducting the fair value of the warrants of US\$1.05 from the US\$4.13 Unit price and the exercise price of US\$0.01 (see Note 16(a)).

Based on the above fair value, the issuance of the over-allotment pre-funded warrants and warrants to the underwriter resulted in a non-cash charge of \$251,877, which is included in the change in fair value of warrant liabilities in the consolidated statements of net loss and comprehensive loss.

At September 30, 2023, we remeasured the fair value of these warrants using the following assumptions:

	2022	Over-allotment	
	Warrants ⁽¹⁾⁽²⁾	Pre-Funded Warrants ⁽³⁾	Over-allotment Warrants ⁽¹⁾
Number of securities	3,282,533	199,000	375,000
Nasdaq closing price (in USD)	\$ 0.24	\$ 1.55	\$ 0.24
Exchange rate (USD/CAD)	\$ 1.352	\$ 1.352	\$ 1.352
Fair value per warrant (CAD)	\$ 0.32	\$ 2.08	\$ 0.32

(1) Fair value is based on the Nasdaq closing pricing on September 30, 2023, for the warrants.

(2) Includes debt settlement warrants.

(3) Fair value is measured at the Nasdaq closing price on September 30, 2023, for the underlying common stock less US\$0.01 exercise price.

December 2022 Debt Settlement

On December 13, 2022, we entered into share for debt arrangements with existing lenders (see Note 16(a)), which resulted in issuing 56,141 Units, same terms as the Units as issued in the Canadian Offering except that the underlying securities are subject to a four-month hold period. Accordingly, this resulted in issuing 56,141 common shares and 56,141 warrant liabilities with an exercise price of US\$5.00 per share and maturing on December 13, 2027. We initially recorded the fair value of the warrant liabilities using the Black Scholes option pricing model with an underlying stock price equivalent to the unit price of US\$4.13.

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

At September 30, 2023, we remeasured the fair value of these warrant liabilities using the Nasdaq closing price on September 30, 2023, of US\$0.24. The remeasurement resulted in a change in fair value of warrant liabilities \$62,476 for the year ended September 30, 2023, which was reported in the consolidated statements of net loss and comprehensive loss.

Private Placement

On July 21, 2023, we closed an underwritten U.S. private placement for gross proceeds of CAD\$7.4 million (US\$5.59 million) (see Note 16(a)). As part of the private placement, we have issued 1,542,194 warrants (the “2023 Warrants”) with an exercise price of US\$2.66 per share. Additionally, 930,548 pre-funded Warrants with an exercise price of US\$0.001 per share for US\$2.259 per pre-funded warrant were issued.

Refer to Note 16(a) for further information on the private placement.

Under IFRS, the above securities are classified as financial liabilities (referred herein as “warrant liabilities”) because the exercise price is denominated in U.S. dollars, which is different to our functional currency (Canadian dollars). Accordingly, the ultimate proceeds in Canadian dollars from the potential exercise of the above securities are not known at inception. These financial liabilities are classified and measured at FVTPL (see Note 3(c)). Gains on revaluation of the warrant liabilities are presented in other income (expenses) on the consolidated statements of net loss and comprehensive loss.

Warrant liabilities

The 2023 warrants issued in the private placement were not listed on Nasdaq and does not represent an active market Level 1 input. Accordingly, at inception, the 2023 Warrants were measured at fair value using the Black Scholes option pricing model (Level 2). We used the following assumptions:

	2023 Warrants	Pre-Funded Warrants ⁽¹⁾
Number of dilutive securities	1,542,194	930,548
Exercise price (in USD)	\$ 2.66	\$ 0.001
Share price (in USD)	\$ 2.08	\$ 2.08
Expected life	2.50	
Dividend	\$ -	
Volatility	67%	
Risk free rate	4.44%	
Exchange rate (USD/CAD)	\$ 1.321	\$ 1.321
Fair value per warrant (CAD)	\$ 0.99	\$ 1.98

(1) Fair value is measured at the underlying common share closing price on Nasdaq on July 21, 2023, less US\$0.001 exercise price.

The share price (in USD) for the pre-funded warrants was based on the estimated fair value of the common shares issued on July 21, 2023, by deducting the fair value of the warrants of US\$0.75 from the US\$2.26 Unit price and the exercise price of US\$0.001 (see Note 16(a)).

At September 30, 2023, we remeasured the fair value of these warrants using the following assumptions:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	2023 Warrants ⁽¹⁾	Pre-Funded Warrants ⁽²⁾
Number of securities	1,542,194	930,548
Nasdaq closing price (in USD)	\$ -	\$ 1.55
Black Scholes fair value (in USD)	\$ 0.38	\$ -
Exchange rate (USD/CAD)	\$ 1.352	\$ 1.352
Fair value per warrant (CAD)	\$ 0.52	\$ 2.08

(1) Fair value is based on the Black Scholes model on September 30, 2023, for the warrants.

(2) Fair value is measured at the Nasdaq closing price on September 30, 2023, for the underlying common stock less US\$0.001 exercise price.

16. Share capital and Contributed Surplus

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

a) Share capital

Authorized

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

Issued Common Shares

	September 30, 2023		September 30, 2022		September 30, 2021	
	Number	Amount	Number	Amount	Number	Amount
Balance, beginning of year	773,225	\$ 19,496,640	699,511	\$ 17,215,068	589,518	\$ 9,374,563
Issued for U.S. IPO and Canadian Offering	3,226,392	\$ 13,675,120	-	\$ -	-	\$ -
Issued in private placement	1,542,194	\$ 3,050,316	22,857	\$ 272,000	10,714	\$ 1,110,000
Issued for debt settlements	56,141	\$ 233,485	143	\$ 19,000	1,305	\$ 63,866
Issued for conversion of share units	14,134	\$ 529,504	8,349	\$ 874,840	138	\$ 12,498
Issued for exercise of warrants	3,571	\$ 60,000	19,000	\$ 277,098	10,380	\$ 815,307
Issued for exercise of stock options	1,125	\$ 5,836	-	\$ -	18,195	\$ 1,292,015
Issued for bonus shares relating to borrowings (Note 10)	-	\$ -	18,525	\$ 411,692	-	\$ -
Issued for acquisition (Note 4(a))	-	\$ -	3,965	\$ 377,503	-	\$ -
Issued for conversion of contingent shares (Note 4(a))	-	\$ -	875	\$ 83,319	-	\$ -
Issued in brokered private placement	-	\$ -	-	\$ -	51,087	\$ 3,611,818
Issued for asset acquisition (Note 4(b))	-	\$ -	-	\$ -	14,286	\$ 1,290,000
Issued for exercise of broker compensation options	-	\$ -	-	\$ -	2,459	\$ 347,680
Issued for amended license (Note 27)	-	\$ -	-	\$ -	1,429	\$ 137,000
Less: share offering costs for the year	-	\$ (3,671,791)	-	\$ (33,880)	-	\$ (839,679)
Balance, end of year	5,616,782	\$ 33,379,110	773,225	\$ 19,496,640	699,511	\$ 17,215,068

2023 Activities

Share Consolidation

On October 28, 2022, we finalized the consolidation of our common shares on the basis of one post-consolidation common share for every seventy pre-consolidation common shares issued and outstanding.

U.S. IPO and Canadian Offering

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

On December 9, 2022, we closed the U.S. IPO and the Canadian Offering. In the U.S. IPO, we sold 2.5 million units at a public offering price of USD \$4.13 per unit (the “Unit”), consisting of one share of common stock and one warrant to purchase one share of common stock (“Warrant”). The Warrants have a per share exercise price of USD \$5.00 and can be exercised immediately. In connection with the closing of the U.S. IPO, the underwriter partially exercised its over-allotment option to purchase an additional 199,000 pre-funded common share purchase warrants (“Pre-Funded Warrants”) at US\$4.12 (before underwriter discount) and 375,000 option warrants to purchase common shares at US\$0.0001 each. A Pre-Funded Warrant is a financial instrument that requires the holder to pay little consideration (exercise price of US\$0.01) to receive the common share upon exercise of the Pre-Funded Warrant (see Note 15). The holder of Pre-Funded Warrants has no voting rights. All of these warrants expire on December 9, 2027.

In the Canadian Offering, we sold 726,392 units, each consisting of one common share and one warrant to purchase one common share, at a price to the public of USD \$4.13 per unit. The warrants will have a per common share exercise price of USD \$5.00, are exercisable immediately and expire in five years on December 9, 2027. Effective May 1, 2023, the warrants are listed on the TSX-V under the stock symbol of KWE.WT.U.

The closing of the U.S. IPO and Canadian Offering resulted in aggregate gross proceeds of CAD\$19.4 million (USD \$14.1 million), before deducting underwriting discounts and offering expenses.

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

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

Accounting Treatment

Refer to Note 15 for the accounting of the warrants issued in the U.S. IPO and Canadian Offering and the July Private Placement accounted for as warrant liabilities.

The U.S. underwriter warrants as well as the Canadian broker options from the U.S. IPO and Canadian Offering, 134,950 warrants and 50,848 warrants respectively, were accounted for as equity on initial recognition. The U.S. underwriter warrants from the July Private Placement, 123,637 warrants, was accounted for as equity on initial recognition.

Brokers’ Compensation and Share Offering Costs

As consideration for the services provided in connection with the U.S. IPO, ThinkEquity received: (a) a broker-dealer cash commission of US\$835,000 (or CAD\$1,138,105) equal to 7.5% of the gross offering proceeds of the U.S. Offering; and (b) underwriter warrants (the “U.S. Underwriter Warrants”) to purchase up to 134,950 common shares equal to 5% of the common shares and pre-funded common share purchase warrants issued under the U.S. Offering. Each U.S. Underwriter Warrant is exercisable to acquire one common share at a price of US\$5.1625, exercisable as of June 4, 2023, and expiring on December 9, 2027.

As consideration for the services provided in connection with the Canadian Offering, PI Financial received: (a) a cash commission of approximately US\$210,000 (or CAD\$286,230); and (b) 50,848 compensation options (the “Canadian Compensation Options”). Each Canadian Compensation Option is exercisable to acquire one Canadian Unit at a price of US\$4.13 and expiring on December 9, 2024.

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

In addition to the above brokers' compensation, we also incurred US\$2.1 million share offering costs (or CAD\$2.8 million) for the U.S. IPO and Canadian Offering, of which CAD\$628,262 was incurred and deferred at September 30, 2022.

The total brokers compensation (including fair value of U.S. Underwriter Warrants and Canadian Compensation Options) and share offering costs was US\$3.2 million (or CAD\$4.4 million). This total was allocated proportionately to the fair value of common shares and to share offering costs for the portion allocated to warrants accounted for as warrant liabilities.

Shares for Debt Settlement

We entered into share for debt arrangements with existing lenders, which closed on December 13, 2022, following TSXV's conditional approval. This resulted in issuing 56,141 Units to settle \$12,000 of the March 2022 Loans and USD\$223,321 (or CAD\$302,197) of the August 2022 Loans, including unpaid accrued interest and 10% premium at maturity (the "Debt Settlements") (see Note 12). The terms of the Units are the same as the Units issued in the Canadian Offering.

Private Placement

On July 21, 2023, we closed a brokered private placement, resulting in the issuance of 1,542,194 common shares of KWESST, for aggregate gross proceeds of USD\$5,588,397 (approximately CAD\$7.4M) (the "July 2023 Offering").

As a part of the July 2023 Offering, the Company issued 1,542,194 common shares at a price of US\$2.26 (CAD\$2.98) per common share (each a "Common Share") and 930,548 pre-funded warrants at a price of US\$2.259 (CAD\$2.979) per pre-funded warrant (each a "Pre-funded Warrant"), with each Common Share and Pre-funded Warrant being bundled with one common share purchase warrant of the Company (each a "Common Warrant"). Each Pre-Funded Warrant entitles the holder to acquire one Common Share at an exercise price of US\$0.001 per Common Share, and each Common Warrant is immediately exercisable and entitles the holder to acquire one Common Share at an exercise price of US\$2.66 (CAD\$3.50) per Common Share for a period of 60 months following the closing of the July 2023 Offering. Although the Common Shares and Pre-funded Warrants are each bundled with a Common Warrant, each security is issued separately.

Brokers' Compensation and Share Offering Costs

ThinkEquity acted as sole placement agent for the Offering. As compensation for services rendered, the Company paid to ThinkEquity a cash fee of \$475,013.14 representing 8.5% of the aggregate gross proceeds of the Offering and issued 123,637 warrants to purchase a number of Common Shares (the "Placement Agent Warrants"), representing 5% of the Common Shares and Pre-Funded Warrants sold in the Offering. The Placement Agent Warrants will be exercisable, in whole or in part, immediately upon issuance and will expire 60 months after the closing date of the Offering at an initial exercise price of US\$2.66 (CAD\$3.50) per Common Share.

2022 Activities

Private Placement

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

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

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

Police Ordinance Acquisition

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

Debt for Equity Settlement

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

2021 Activities

Brokered Private Placement

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

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

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

Asset Acquisition

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

Private Placement

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

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

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

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

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

Amended License

In April 2021, we issued 1,429 common shares for the exclusivity with AerialX as disclosed in Note 27.

Debt for Equity Settlement

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

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

b) Warrants

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

The following reflects the warrant activities:

	September 30, 2023		September 30, 2022		September 30, 2021	
	Number of warrants	Weighted average exercise price	Number of warrants	Weighted average exercise price	Number of warrants	Weighted average exercise price
Outstanding, beginning of year	13,417,156	\$ 0.78	13,901,640	\$ 0.74	9,585,050	\$ 0.24
Issued	6,587,862	\$ 5.29	1,000,000	\$ 0.57	5,043,165	\$ 1.73
Exercised	(250,000)	\$ 0.50	(1,330,000)	\$ 0.26	(726,575)	\$ 1.05
Expired	(4,247,156)	\$ 1.86	(154,484)	\$ 0.56	-	\$ -
Outstanding, end of year	15,507,862	\$ 2.49	13,417,156	\$ 0.78	13,901,640	\$ 0.74
Exercisable, end of year	15,382,862	\$ 2.50	12,792,156	\$ 0.82	12,901,640	\$ 0.75

The following table provides additional information on the total outstanding warrants at September 30, 2023:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	Number outstanding	Conversion ratio to Common Shares	Book value	Expiry Date
Classified as Equity				
<i>Founders' warrants:</i>				
Exercise price of \$0.20	5,520,000	70 for 1	\$ 1,013	January 1, 2024
Exercise price of \$0.20	1,900,000	70 for 1	\$ 18,865	June 14, 2024
<i>LEC's warrants:</i>				
Exercise price of \$0.70	500,000	70 for 1	\$ 425,000	April 29, 2026
<i>Acquisition of Police Ordinance (Note 4):</i>				
Exercise price of \$1.72	200,000	70 for 1	\$ 132,000	December 15, 2024
<i>July 2022 equity financing:</i>				
Exercise price of \$0.285	800,000	70 for 1	\$ 72,000	July 14, 2024
<i>December 2022 U.S. Underwriter Warrants</i>				
Exercise price of US\$5.1625	134,950	1 for 1	\$ 189,592	December 6, 2024
<i>July 2023 U.S. Underwriter Warrants</i>				
Exercise price of US\$2.66	123,637	1 for 1	\$ 204,187	December 6, 2024
	9,178,587		\$ 1,042,657	
Classified as liability				
<i>December 2022 public offerings:</i>				
Exercise price of US\$5.00	3,226,392	1 for 1	\$ 1,042,538	December 9, 2027
<i>December 2022 Pre-Funded Warrants</i>				
Exercise price of US\$0.01	199,000	1 for 1	\$ 414,334	No expiry
<i>December 2022 Option Warrants</i>				
Exercise price of US\$5.1625	375,000	1 for 1	\$ 121,173	December 9, 2024
<i>December 2022 debt settlement</i>				
Exercise price of US\$5.00	56,141	1 for 1	\$ 18,141	December 9, 2027
<i>July 2023 public offerings:</i>				
Exercise price of US\$2.66	1,542,194	1 for 1	\$ 798,573	July 21, 2028
<i>July 2023 Pre-Funded Warrants</i>				
Exercise price of US\$0.001	930,548	1 for 1	\$ 1,940,914	No expiry
	6,329,275		4,335,673	
Total outstanding warrants	15,507,862		\$ 5,378,330	

The fair value for the warrants issued during the year ended September 30, 2023, was determined by the Black Scholes option pricing model using the following key inputs:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	2023	2022
	Warrants	Warrants
Exercise Price (in USD)	\$ 2.66	\$ 5.00
Stock price (in USD)	\$ 2.08	\$ 4.13
Volatility	67%	75%
Dividend Yield	Nil	Nil
Risk-free interest rate	4.44%	4.20%
Expected life	2.5	2.5

Weighted average fair value per warrant	\$ 0.99	\$ 1.43
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The fair value for the warrants issued during the year ended September 30, 2022, was determined by the Black Scholes option pricing model using the following key inputs:

	Acquisition of	July 2022
	POC	Warrants
Exercise Price	\$ 1.72	\$ 0.285
1/70 of stock price	\$ 1.36	\$ 0.215
Volatility	84.7%	90.5%
Dividend Yield	Nil	Nil
Risk-free interest rate	1.04%	3.12%
Expected life	3	2

Weighted average fair value per warrant	\$ 0.66	\$ 0.09
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The fair value for the warrants issued during the year ended September 30, 2021, was determined by the following valuation models and key inputs:

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

c) Contributed Surplus

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

Broker Compensation Options

In the Canadian Offering, we issued 50,848 Canadian Compensation Options. Each Canadian Compensation Option is exercisable to acquire one Unit, as defined in Note 16(a), at a price equal to US\$4.13 for a period of two years (expiring on December 9, 2024). Based on the structure of the Compensation Option, management estimated its fair value using the Monte Carlo method (Level 2). We used the following key inputs in the Monte Carlo model (100,000 simulations):

	Initial Recognition
Number of securities	50,848
Exercise price - compensation option (in USD)	\$ 4.13
1-Year CAD/USD Forward Exchange Rate	\$ 1.3560
Exercise price - compensation warrant (in USD)	\$ 5.00
2-Year CAD/USD Forward Exchange Rate	\$ 1.3483
Share price (in CAD)	\$ 4.20
Expected life - compensation option	1.00
Expected life - compensation warrant	2.50
Dividend	\$ -
Volatility - compensation option	90%
Volatility - compensation warrant	75%
Risk free rate - compensation option	4.38%
Risk free rate - compensation warrant	3.15%
Fair value per compensation option (CAD)	\$ 2.46

We have recorded \$125,086 of Canadian Compensation Options in contributed surplus, with an equal offset to share offering costs (a non-cash transaction).

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

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

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

Share-based compensation

On March 31, 2023, KWESST shareholders approved the renewal of the Long-Term Incentive Plan (the "LTIP"). Additionally, the disinterested shareholders of KWESST approved an amendment to the LTIP to increase the number of RSUs, PSUs, DSUs, and SARs (collectively "Share Units") authorized for issuance pursuant to the LTIP from 60,682 to 407,274 Share Units. Accordingly, we have 11,153 Share Units available for future grants.

Further, the disinterested shareholders (shareholders that are not directors, officers, or other insiders of the Company) of KWESST approved to revise the exercise price of 50,981 stock options to \$3.60, the closing price of KWESST common shares on the TSX-V on March 31, 2023. In accordance with IFRS 2, this resulted in an immediate fair value increase of \$77,001 included in share-based compensation, with an offset to contributed surplus.

During the year ended September 30, 2023, we granted 340,000 stock options and did not grant any RSUs, PSUs, or SARs, pursuant to our LTIP during the year ended September 30, 2023. Accordingly, we had 389,907 outstanding stock options at September 30, 2023.

For the year ended September 30, 2023, we recorded share-based compensation of \$373,554, (2022 - \$1,960,072, 2021 - \$2,462,207).

(i) Stock Options

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

	Number of options	Weighted average exercise price
Outstanding at September 30, 2020	28,838	\$ 45.50
Granted	52,988	\$ 104.30
Exercised	(18,194)	\$ 50.40
Cancelled	(4,096)	\$ 48.30
Outstanding at September 30, 2021	59,536	\$ 95.90
Granted	9,500	\$ 69.59
Cancelled	(11,928)	\$ 131.76
Outstanding at September 30, 2022	57,108	\$ 83.87
Granted	340,000	\$ 2.59
Exercised	(1,125)	\$ 3.60
Cancelled	(6,076)	\$ 70.65
Outstanding at September 30, 2023	389,907	\$ 2.80
Options exercisable at September 30, 2023	49,496	\$ 4.21

During the year ended September 30, 2023, we granted 340,00 (2022 – 9,500, 2021 – 52,988) options at a weighted average exercise price of \$2.59 (2022 – \$69.59, 2021 – \$104.30). At September 30, 2023, the weighted average remaining vesting period was 1.87 years (2022 – 0.88 years, 2021 – 1.82 years).

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

For the options granted during the year ended September 30, 2023, the per share weighted-average fair value of stock options was \$1.42 (2022 – \$38.21, 2021 – \$50.40), using the Black-Scholes option model with the following weighted-average assumptions:

	2023	2022	2021
Stock price	\$2.55 to \$4.00	\$14.70 to \$126.70	\$49.00 to \$159.60
Exercise price	\$2.55 to \$4.00	\$14.70 to \$126.70	\$49.00 to \$159.60
Volatility	96.37%	90.48%	76.46%
Dividend yield	Nil	Nil	Nil
Risk-free interest rate	4.65%	2.04%	0.35%
Expected life (years)	2.93	2.91	2.26
Weighted-average fair value per option	\$ 1.42	\$ 38.21	\$ 50.40

The following table summarizes information about stock options outstanding at September 30, 2023:

Exercise price	Number outstanding	Weighted average remaining contractual life	Weighted average outstanding strike price	Exercisable	Remaining exercisable contractual life	Weighted average exercisable strike price
\$2.55	330,000	2.88	2.55	-	-	-
\$3.60	49,550	2.55	3.60	49,139	2.54	3.60
\$4.06	10,000	4.62	4.06	-	-	-
\$87.50	357	2.76	87.50	357	2.76	87.50
	389,907	2.88	2.80	49,496	2.54	4.21

Amendment to stock option grants

For the years ended September 30, 2023 and 2022, we had no amended stock option grants.

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

(ii) Share Units

The following table shows the changes in Share Units:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	RSUs	PSUs	SARs	Total
Outstanding at September 30, 2020	-	-	-	-
Granted	16,412	2,857	2,143	21,412
Vested and converted	(139)	-	-	(139)
Outstanding at September 30, 2021	16,273	2,857	2,143	21,273
Granted	10,726	17,942	514	29,182
Vested and converted to common shares	(5,681)	(2,666)	-	(8,347)
Vested and repurchased for withholding taxes	(144)	(249)	-	(393)
Expired / cancelled	-	(17,714)	-	(17,714)
Outstanding at September 30, 2022	21,174	170	2,657	24,001
Granted	-	-	-	-
Vested and converted to common shares	(20,103)	(170)	-	(20,273)
Vested and repurchased for withholding taxes	-	-	-	-
Expired / cancelled	-	-	-	-
Outstanding at September 30, 2023	1,071	-	2,657	3,728

RSUs:

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

During the year ended September 30, 2023, we granted nil RSUs (2022 – 10,726, 2021 – 16,412), with a weighted-average grant date fair value of \$nil per unit (2022 – \$43.50, 2021 – \$105.70). The weighted average vesting period for the outstanding RSUs was 0.1 years at September 30, 2023 (2022 – 0.18 years, 2021 – 0.69 years).

PSUs:

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

During the year ended September 30, 2023, we granted nil PSUs (2022 – 17,942, 2021 – 2,857), with a weighted-average grant date fair value of \$nil per unit (2022 – \$126.70, 2021 – \$105.00). The outstanding PSUs were fully vested at September 30, 2023 (2022 – fully vested, 2021 – Weighted average vesting period was 0.40 years).

SARs:

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

During the year ended September 30, 2023, we granted nil SARs (2022 – 514, 2021 – 2,143) at an exercise price of \$nil (2022 – \$126.70, 2021 – \$115.50 each). The 2,657 SARs will expire on January 22, 2024.

(iii) Share-based Compensation

For the year ended September 30, 2023, we recorded share-based compensation of \$373,554 (2022 – \$1,960,072, 2021 – \$2,462,207).

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
General and administrative	\$ 246,436	\$ 1,104,858	\$ 1,425,111
Selling and marketing	53,800	552,627	754,167
Research and development, net	73,318	302,587	282,929
Total share-based compensation	\$ 373,554	\$ 1,960,072	\$ 2,462,207

17. Earnings (loss) per share

The following table summarizes the calculation of the weighted average basic number of basic and diluted common shares to calculate the earnings (loss) per share as reported in the statements of net loss and comprehensive loss:

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
Issued common shares, beginning of year	773,225	699,511	589,518
<i>Effect of shares issued from:</i>			
December 2022 U.S. IPO and Canadian Offering (Note 16)	2,607,632	-	-
Over-allotment Pre-Funded Warrants (Note 15)	160,836	-	-
July 2023 Private Placement (Note 16)	299,988	-	-
July 2023 Pre-Funded Warrants (Note 15)	181,011	-	-
Debt settlements	44,759	132	1,038
Conversion of stock units	11,817	3,703	31
Exercise of options	2,671	-	9,118
Exercise of warrants	336	10,593	4,383
Issuance of bonus shares (Note 12)	-	8,262	-
Private placements	-	4,571	21,810
Acquisition of Police Ordnance (Note 4(a))	-	3,144	-
Conversion of contingent shares (Note 4(a))	-	386	-
Asset acquisitions (Note 4(b))	-	-	6,027
Amended license agreement	-	-	626
Exercise of broker options	-	-	170
Weighted average number of basic common shares	4,082,275	730,302	632,721
<i>Dilutive securities:</i>			
Stock options	-	-	-
Warrants	-	-	-
Weighted average number of dilutive common shares	4,082,275	730,302	632,721

At September 30, 2023, 2022 and 2021, all the stock options and warrants were anti-dilutive because we incurred a net loss for the periods.

As the \$0.01 and \$0.001 exercise price per Pre-Funded Warrant is non-substantive, the 199,000 Pre-Funded Warrants issued in the U.S. IPO and the 930,548 Pre-Funded Warrants issued in the July 2023 Private Placement are included in the basic net loss per share calculation.

18. Revenue

a) Revenue streams

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

b) Disaggregation of revenue from contracts with customers

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

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
<i>Major products / service lines</i>			
Digitization	\$ 819,604	\$ 354,620	\$ 1,255,982
Non-Lethal	411,758	330,658	-
Training and services	-	34,590	-
Other	3,088	1,651	19,822
	\$ 1,234,450	\$ 721,519	\$ 1,275,804
<i>Primary geographical markets</i>			
United States	\$ 42,780	\$ 389,210	\$ 1,238,063
Canada	743,200	332,309	37,741
Europe	448,470	-	-
	\$ 1,234,450	\$ 721,519	\$ 1,275,804
<i>Timing of revenue recognition</i>			
Products and services transferred over time	\$ 819,604	\$ 389,210	\$ 1,238,063
Products transferred at a point in time	414,846	332,309	37,741
	\$ 1,234,450	\$ 721,519	\$ 1,275,804

Revenue allocated to remaining performance obligations represents contracted revenue that has not yet been recognized (“contracted not yet recognized”) and includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods. At September 30, 2023, our contracted not yet recognized revenue was \$496,199 (2022 – \$625,177, 2021 – \$16,545), of which 76% of this amount is expected to be recognized over the next 12 months with the remaining 25% expected to be recognized in 2 to 3 years.

For the year ended September 30, 2023, one customer accounted for 23% of revenue and one customer accounted for 18% of revenue (2022 – one customer accounted for 41%, 2021 – one customer accounted for 95%).

19. Expenses by nature

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
Employee benefits	\$ 3,011,923	\$ 4,883,062	\$ 4,746,316
Advertising and promotion	19,090	1,352,750	1,914,630
Consulting fees	2,743,272	1,315,917	1,138,782
Professional fees	940,667	1,028,240	778,337
Travel and conferences	804,481	518,140	246,418
R&D consulting and material costs, net	556,013	420,378	482,348
Depreciation and amortization	952,508	326,491	140,990
Impairment of intangible assets	1,174,354	-	-
Other expenses	691,566	266,822	252,961
Insurance	716,931	236,150	154,931
Transfer agent and listing fees	120,690	94,885	110,769
Royalty and license costs	305,918	-	287,000
M&A costs	-	-	-
Total expenses	12,037,413	10,442,835	10,253,482
Allocation to cost of sales:			
Employee benefits	(123,803)	(166,706)	(574,018)
Total operating expenses	\$ 11,913,610	\$ 10,276,129	\$ 9,679,464

20. Depreciation and Amortization

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

	2023	2022	2021
General and administrative	\$ 833,029	\$ 123,960	\$ 95,310
Selling and marketing	77,804	129,265	16,443
Research and development	41,675	73,266	29,237
Total depreciation and amortization	\$ 952,508	\$ 326,491	\$ 140,990

21. Net finance costs

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
Interest expense from:			
Unsecured loan	\$ 503,251	\$ 321,313	\$ 4,527
Accretion cost - accrued royalties liability	170,373	159,451	64,537
Lease obligations	37,786	30,112	33,872
Related party loans	-	-	4,581
CEBA term loan	8,281	-	4,481
2019 convertible notes	-	-	-
Other	3,857	1,114	4,115
Total interest expense	723,548	511,990	116,113
Interest income	(55,514)	(5,988)	(4,848)
Gain on termination of lease obligations	-	-	-
Gain on government grant	-	-	(3,514)
Net finance costs	\$ 668,034	\$ 506,002	\$ 107,751

22. Income taxes

a) Income tax recovery

Income tax recovery is made up of the following components:

	Year end ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
Current income tax recovery (expense):	-	-	-
Deferred income tax (recovery) expense:	-	(49,442)	-
	\$ -	\$ (49,442)	\$ -

b) Reconciliation of effective income tax rate

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
Loss before income taxes	\$ (9,306,360)	(10,569,732)	(9,315,372)
Expected statutory tax rate	26.5%	26.5%	26.5%
Expected tax recovery resulting from loss	(2,466,185)	(2,800,979)	(2,468,574)
Increase (reduction) in income taxes resulting from:			
Non-deductible expenses	149,270	563,842	654,956
Foreign operations subject to different tax rates	1,447	5,329	3,593
Fair value of warrant liabilities	(1,547,916)		
Unrecognized temporary differences	3,863,384	2,182,366	1,826,279
Prior year differences	-	-	(16,254)
	\$ -	\$ (49,442)	\$ -

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

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
R&D expenses	\$ 1,644,565	\$ 2,064,493	\$ 2,369,145
Less:			
Investment tax credits	-	-	(231,007)
R&D expenses, net	\$ 1,644,565	\$ 2,064,493	\$ 2,138,138

c) Deferred tax balances

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

	Balance at September 30, 2022	Arising on a business combination	Recognized in profit or loss	Balance at September 30, 2023
<i>Deferred tax assets (liabilities):</i>				
Net operating loss carryforwards	26,459	-	(9,590)	16,869
Intangibles and development costs	(26,459)		9,590	(16,869)
	-	-	-	-

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

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

d) Unrecognized net deferred tax assets

Deferred taxes reflect the impact of loss carryforwards and of temporary differences between amounts of assets and liabilities for financial reporting purposes and such amounts as measured by enacted tax laws. However, KWESST has not recorded net deferred tax assets at September 30, 2023 and 2022 on the following deductible temporary differences, due to the uncertainty involved in determining whether these deferred tax assets will be realized upon expiration due to KWESST's limited history and cumulative operating losses since its inception.

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

	Balance at September 30, 2023	Balance at September 30, 2022	Balance at September 30, 2021
Net operating loss carryforwards	\$ 30,178,141	\$ 18,589,894	\$ 9,429,436
Share issuance costs	5,275,081	1,298,783	1,810,927
Intangibles and development costs	1,356,922	608,705	780,607
Scientific research and development expenditures	1,583,058	1,583,058	1,789,571
Other	1,467,509	46,300	104,793
	\$ 39,860,711	\$ 22,126,741	\$ 13,915,334

e) Available net operating losses

At September 30, 2023, KWESST has the following net operating losses in Canada available to reduce future year's taxable income which expire as follows:

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

Year of Expiry	Amount
2036	\$ 512,163
2037	744,022
2038	1,174,797
2039	1,732,039
2040	336,562
2041 and thereafter	25,678,558
	\$ 30,178,141

f) Available research and development investment tax credits

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

Year of Expiry	Amount
2037	\$ 13,361
2038	6,742
2039	-
2040	328,480
2041 and thereafter	-
	\$ 348,583

23. Financial instruments

Fair value of financial instruments

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

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

Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities;

Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

Level 3: inputs for the asset or liability that are not observable market data (unobservable inputs).

The lease deposit, lease obligations, accrued royalties liability, warrant liabilities and borrowings were recorded at fair value at initial recognition. The fair value measurement for these was Level 2. Subsequently, these were measured at amortized cost and accreted to their nominal value over their respective terms. At September 30, 2023, the fair value for accrued royalties liability determined using a discount rate of 24% (2022 – 24%, 2021 – 13.7%) would be \$928,776 (2022 – \$869,219, 2021 – \$1,105,756). Using the same market discount rate, the fair value of the borrowings would be \$nil at September 30, 2023 (2022 – \$68,750, 2021 – \$49,825).

Financial risk management

We are exposed to a number of financial risks arising through the normal course of business as well as through its financial instruments. Our overall business strategies, tolerance of risk and general risk management

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

philosophy are determined by our Board of Directors in accordance with prevailing economic and operating conditions.

(a) Interest rate risk

Interest rate risk is the risk that the fair value of cash flows of a financial instrument will fluctuate because of changes in market interest rates. At September 30, 2023, our loans were all repaid and therefore not subject to interest rate risk. At September 30, 2022, our borrowings were all subject to fixed interest rates and therefore these were not subject to interest rate risk. At September 30, 2021, our borrowing was interest free.

(b) Foreign currency risk

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

For the years ended September 30, 2023, 2022 and 2021, our revenue was substantially denominated in U.S. dollar driven by contracts with U.S. prime contractors in the defense sector. We also procure certain raw materials denominated in U.S. dollar for product development. Accordingly, we are exposed to the U.S. dollar currency. Where a natural hedge cannot be achieved, a significant change in the U.S. dollar currency could have a significant effect on our financial performance, financial position, and cash flows. Currently, we do not use derivative instruments to hedge its U.S. dollar exposure.

At September 30, 2023, we had the following net U.S. dollar exposure:

	Total USD
Net assets in U.S. subsidiary	\$ -
US denominated:	
Assets	\$ 2,926,334
Liabilities	(59,552)
Net US dollar exposure	\$ 2,866,782
Impact to profit or loss if 5% movement in the US dollar	\$ 143,339

During the year ended September 30, 2023, we recorded foreign exchange loss of \$98,275 (2022 – foreign exchange gain of \$28,780, 2021 – foreign exchange loss of \$3,742).

(c) Credit risk

Credit risk is the risk of financial loss to KWESST if a counterparty to a financial instrument fails to meet its contractual obligations. Our credit risk exposure is limited to cash, and trade and other receivables. Refer to Note 5 for the breakdown of our trade and other receivables. We enter into contracts with either large, financially sound global general contractors or law enforcement agencies, which mitigates the credit risk. At September 30, 2023, our trade receivable was \$68,530 (2022 – \$114,877, 2021 – \$nil), of which \$31,527 was overdue by more than 60 days from law enforcement agencies.

(d) Liquidity risk

Liquidity risk is the risk that we will be unable to meet our financial obligations as they become due. Our objective is to ensure that we have sufficient cash to meet our near-term obligations when they become due, under both normal and stressed condition, without incurring unacceptable losses or risking reputational damage

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

to KWESST. A key risk in managing liquidity is the degree of uncertainty in our cash flows due to our early stage in operations and the need for additional capital to fund our business strategies (see Note 2(a)).

At September 30, 2023, our contractual obligations were as follows:

Payment due:	Total	Within 1 Year	1 to 3 years	3 to 5 years	5 years and beyond
Minimum royalty commitments	\$ 2,350,000	\$ 150,000	\$ 400,000	\$ 500,000	\$ 1,300,000
Accounts payable and accrued liabilities	1,649,876	1,649,876	-	-	-
Lease obligations	558,755	197,367	355,430	5,958	-
Total contractual obligations	\$ 4,558,631	\$ 1,997,243	\$ 755,430	\$ 505,958	\$ 1,300,000

At September 30, 2023, we had \$5,407,009 in cash and \$458,439 in positive working capital (current assets less current liabilities).

24. Supplemental cash flow information

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

	Year ended September 30, 2023	Year ended September 30, 2022	Year ended September 30, 2021
Trade and other receivables	\$ (128,387)	\$ 631,801	\$ (218,334)
Inventories	(148,850)	49,446	17,555
Prepaid expenses and other	(440,242)	425,876	(106,205)
Accounts payable and accrued liabilities	(1,666,486)	2,515,289	(828,698)
Contract liabilities	73,699	17,410	(7,053)
Deposits	-	-	150,000
Accrued royalties liability	-	-	1,191,219
	\$ (2,310,266)	\$ 3,639,822	\$ 198,484

The following is a summary of non-cash items that were excluded from the Statements of Cash Flows for the year ended September 30, 2023:

- \$2,924,880 non-cash share offering costs and \$453,102 accounts payables as part of the net proceeds settlement at the closing of the U.S. IPO and Canadian Offering;
- 250,000 warrants exercised in connection with the GhostStep™ acquisition in June 2020; and
- \$529,504 of shares issued for vested RSUs and PSUs.

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

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

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

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

25. Segmented information

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

At September 30, 2023, we had one right-of-use asset (\$79,867) and some inventory (\$78,039) in the United States while all other property and equipment are located in Canada, at September 30, 2022, and 2021, all of our property and equipment were located in Canada, including the right-of-use assets.

26. Capital management

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

KWESST's capital is composed of the following:

	September 30, 2023	September 30, 2022
Debt:		
Borrowings	\$ -	\$ 2,278,774
Lease obligations	429,523	275,621
Equity:		
Share capital	33,379,110	19,496,640
Warrants	1,042,657	1,959,796
Contributed surplus	4,769,115	3,551,330
Accumulated other comprehensive loss	(39,663)	(101,418)
Accumulated deficit	(35,215,599)	(25,909,239)
Total capital	\$ 4,365,143	\$ 1,551,504

27. Commitments and contingencies

AerialX Drone Solutions ("AerialX")

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

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

In addition to the Exclusive License Shares, we also agreed to issue an additional 1,429 common shares upon AerialX achieving the technical milestones. For the years ended September 30, 2023, 2022 and 2021, AerialX has not delivered on the technical milestones and therefore no recognition was made.

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

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

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

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

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

In accordance with the original agreement dated November 18, 2019, in the first quarter of Fiscal 2020 we made a payment of \$150,000 as an advance for future royalty payments (the "Advance"). This Advance was recorded as a non-current deposit at December 31, 2019, and September 30, 2020. During the year ended September 30, 2021, management performed a recoverability review of all our financial assets, including this Advance. Management made the recoverability assessment on the Advance based on anticipated future sales of the licensed technology. Due to the lack of delivery of a functional prototype during the year ended September 30, 2021, management concluded the timing and volume of future sales of the licensed drone was too uncertain. Accordingly, we took a charge to net loss for the year ended September 30, 2021. This charge is included in general and administrative expenses in the consolidated statements of net loss and comprehensive loss. As at September 30, 2023, AerialX has not delivered a functional prototype and no further royalties have been paid.

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

28. Subsequent Events

Announces Issuance of Shares in Payment of Certain Obligations

KWESST MICRO SYSTEMS INC.

Notes to Consolidated Financial Statements

Years ended September 30, 2023, 2022, 2021

(Expressed in Canadian dollars, except share amounts)

On October 31, 2023, the Company announced that it will issue 46,706 common shares at a deemed price per share of CAD\$2.09 in settlement of an obligation in an amount of approximately CAD\$97,615. The obligation resulted from a tail obligation relating to services rendered by a third-party consultant, which the Company has elected to pay for in common shares.