

Condensed Consolidated Interim Financial Statements of
KWESST MICRO SYSTEMS INC.

Quarter ended December 31, 2020 and 2019

(Unaudited – in Canadian dollars)

These unaudited condensed consolidated interim financial statements of KWESST Micro Systems Inc. for the quarter ended December 31, 2020 and 2019 have been prepared by management and approved by the Board of Directors on March 5, 2021. These unaudited condensed interim financial statements have not been reviewed by the Company's external auditors.

KWESST MICRO SYSTEMS INC.

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KWESST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Financial Position
At December 31, 2020 and September 30, 2020

<i>In Canadian dollars</i>	<i>Note</i>	December 31, 2020	September 30, 2020
ASSETS			
Cash	11	\$ 1,701,363	\$ 3,073,760
Trade and other receivables	5	506,321	479,291
Prepaid expenses and other		565,814	441,837
Current assets		2,773,498	3,994,888
Property and equipment	6	170,735	174,644
Right-of-use assets	7	495,479	520,440
Intangible assets	8	964,154	644,702
Deposits		23,048	22,337
Other assets	18	150,000	150,000
Non-current assets		1,803,416	1,512,123
Total Assets		\$ 4,576,914	\$ 5,507,011
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)			
Liabilities			
Accounts payable and accrued liabilities	9	\$ 1,043,229	\$ 818,274
Related party loans	10	199,094	218,276
Borrowings	11	53,047	32,273
Lease obligations	12	87,325	78,358
Deferred revenue		-	7,053
Current liabilities		1,382,695	1,154,234
Lease obligations	12	489,539	496,394
Non-current liabilities		489,539	496,394
Total Liabilities		1,872,234	1,650,628
<i>Commitments and contingencies</i>	18		
Shareholders' Equity (Deficit)	13		
Share capital		9,704,045	9,374,563
Contributed surplus		710,676	583,878
Accumulated deficit		(7,710,041)	(6,102,058)
Total Shareholders' equity (deficit)		2,704,680	3,856,383
Total Liabilities and Shareholders' Equity (Deficit)		\$ 4,576,914	\$ 5,507,011

See Note 2(a) Going Concern

See accompanying notes to condensed consolidated interim financial statements.

On behalf of the Board of Directors:

(signed) John McCoach, Director

(signed) David Luxton, Director

KWESST MICRO SYSTEMS INC.

**Condensed Consolidated Interim Statements of Net Loss and Comprehensive Loss
For the three months ended December 31, 2020 and 2019**

<i>In Canadian dollars</i>	<i>Note</i>	Quarter Ended December 31 2020	Quarter Ended December 31 2019
Revenue	19	\$ 146,349	\$ 3,741
Cost of sales		(71,564)	(7,887)
Gross profit		74,785	(4,146)
Operating expenses			
Marketing and investor relations		361,090	-
Personnel costs		317,503	336,457
Business development		231,117	-
Stock-based compensation	13	196,185	-
R&D consulting and material costs, net		156,293	143,762
Professional fees		106,573	96,640
Advertising and promotion		94,337	13,147
Consulting fees		64,127	59,400
Depreciation and amortization	6, 7	38,734	24,485
General and administrative expenses		38,197	(3,752)
Merger and acquisition ("M&A") costs		10,614	-
Travel and conferences		21,975	36,022
Insurance		24,690	7,811
Total operating expenses		1,661,435	713,972
Operating loss		(1,586,650)	(718,118)
Other income (expenses)			
Fair value adjustments on derivatives		-	113,178
Net finance costs	10, 12	(17,948)	(52,231)
Foreign exchange gain (loss)		(3,385)	(41,617)
Total other income (expenses)		(21,333)	19,330
Loss before income taxes		(1,607,983)	(698,788)
Income tax recovery:			
Current tax recovery		-	-
Deferred tax recovery		-	-
Net loss and comprehensive loss		\$ (1,607,983)	\$ (698,788)
Net Loss per share			
Basic and diluted		\$ (0.04)	\$ (0.03)
Weighted average number of shares outstanding			
Basic and diluted	14	41,389,432	20,767,543

See accompanying notes to condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.

Condensed Consolidated Interim Statements of Changes in Shareholders' Equity

For the three months ended December 31, 2020 and 2019

<i>In Canadian dollars</i>	Common Shares		Contributed Surplus			Total
[Refer to Note 13]	Number Issued	Share Capital	Warrants	Options	Deficit	Shareholders' Equity (Deficit)
Balance, September 30, 2019	18,700,200	\$ 648,508	\$ 21,050	\$ -	\$ (1,838,011)	\$ (1,168,453)
Shares issued for cash	5,075,000	1,014,948	-	-	-	1,014,948
Shares for converted debt and accrued interest	3,104,486	620,897	-	-	-	620,897
Net loss	-	-	-	-	(698,788)	(698,788)
Balance, December 31, 2019	26,879,686	\$ 2,284,353	\$ 21,050	\$ -	\$ (2,536,799)	\$ (231,396)
Balance, September 30, 2020	41,266,176	\$ 9,374,563	\$ 277,170	\$ 306,708	\$ (6,102,058)	\$ 3,856,383
Shares for debt settlements	91,626	64,138	-	-	-	64,138
Stock options exercised	334,456	265,344	-	(69,387)	-	195,957
Share-based compensation	-	-	-	196,185	-	196,185
Net loss	-	-	-	-	(1,607,983)	(1,607,983)
Balance, December 31, 2020	41,692,258	\$ 9,704,045	\$ 277,170	\$ 433,506	\$ (7,710,041)	\$ 2,704,680

See accompanying notes to condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Cash Flows
For the three months ended December 31, 2020 and 2019

<i>In Canadian dollars</i>	Note	Quarter ended December 31, 2020	Quarter ended December 31, 2019
OPERATING ACTIVITIES			
Net loss		\$ (1,607,983)	\$ (698,788)
<i>Items not affecting cash:</i>			
Depreciation and amortization	6, 7	38,734	24,485
Share-based compensation	13	196,185	-
Fair value adjustments on derivative liabilities		-	(82,490)
Net finance costs		17,028	19,465
Changes in non-cash working capital items	17	131,034	(16,753)
Interest paid		(4,873)	(5,240)
Income taxes paid		-	-
Cash used in operating activities		(1,229,875)	(759,321)
INVESTING ACTIVITIES			
Acquisition of property and equipment	6	(9,864)	(10,691)
Investments in development projects	8	(319,452)	-
Deposit for advanced royalties		-	(150,000)
Cash flows used in investing activities		(329,316)	(160,691)
FINANCING ACTIVITIES			
Proceeds from the issuance of common shares	13	-	1,014,948
Proceeds from convertible notes and converted to equity	13	-	(31,644)
Proceeds from borrowings	11	20,000	
Repayments to related party loans	10	(21,252)	
Proceeds from related party loans	10	-	(25,000)
Repayments of lease obligations	12	(7,910)	(20,070)
Proceeds from exercise of stock options	13	195,957	
Cash flows provided by financing activities		186,795	938,234
Net change in cash during the period		(1,372,397)	18,222
Cash, beginning of period		3,073,760	3,393
Cash, end of period		\$ 1,701,363	\$ 21,615

See accompanying notes to condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three months ended December 31, 2020 and 2019
(Expressed in Canadian dollars, except share and per share amounts)

1. Corporate information

KWESST Micro Systems Inc. (the "Company" or "KWESST"), was incorporated on November 28, 2017, under the laws of the Province of British Columbia. The Company's registered office is located at 550 Burrard Street, Suite 2900, Vancouver, British Columbia, Canada. Its corporate office is located at Unit 1, 155 Terrence Matthews Crescent, Ottawa, Ontario, Canada.

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

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

2. Basis of preparation

(a) Going concern

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

As an early-stage company, KWESST has incurred significant losses and negative operating cash flows from inception that have primarily been funded from financing activities. KWESST incurred approximately \$1.6 million net loss and negative operating cash flows of approximately \$1.2 million for the three months period ended December 31, 2020 (2019 - \$0.7 million net loss and negative operating cash flows of \$0.8 million) and approximately \$3.6 million net loss and negative operating cash flows of approximately \$1.8 million for the nine months period ended September 30, 2020 (twelve months ended December 31, 2019 - \$1.1 million net loss and negative operating cash flows of \$1.1 million). At December 31, 2020, KWESST had a working capital of \$1.4 million (September 30, 2020 – working capital of \$2.8 million).

The Company's ability to continue as a going concern and realize its assets and discharge its liabilities in the normal course of business is dependent upon closing timely additional sales orders, achieving sustained profitability and the ability to raise additional debt or equity financing, if required, to fund its working capital requirements. There are various risk and uncertainties affecting KWESST's operating including, but not limited to:

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

KWESST's strategy to mitigate these risks and uncertainties is to execute on 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. There are no guarantees that the funds raised will be sufficient to sustain KWESST's ongoing operations beyond twelve months or that additional debt or equity financing will be available to the Company or available at acceptable terms. Failure to implement the Company's business plan could have a material adverse effect on the Company's financial condition and/or

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financial performance. Accordingly, there are material risks and uncertainties that cast significant doubt about KWESST's ability to continue as a going concern.

These condensed consolidated interim financial statements do not include any adjustments or disclosures that would be required if assets are not realized and liabilities and commitments are not settled in the normal course of operations. If KWESST is unable to continue as a going concern, then the carrying value of certain assets and liabilities would require revaluation to a liquidation basis, which could differ materially on the values presented in the financial statements.

(b) Statement of compliance

These condensed consolidated interim financial statements have been prepared in accordance with IAS 34, *Interim Financial Reporting*, ("IAS 34") as issued by the International Accounting Standards Board ("IASB"). They do not include all the disclosures that would otherwise be required for a complete set of financial statements and should be read in conjunction with the annual audited financial statements of KWESST's for the period ended September 30, 2020.

These unaudited condensed consolidated interim financial statements were authorized for issue by the Board of Directors on March 5, 2021.

(b) Basis of consolidation

These condensed consolidated interim financial statements incorporate the financial statements of KWESST and the entity it controls.

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

At December 31, 2020, the Company has one wholly-owned subsidiary: KWESST Inc. Subsequent to December 31, 2020, the Company has incorporated a wholly-owned subsidiary based in the United States named KWESST U.S. Inc. and accordingly, starting with the second quarter of fiscal 2021, the Company will consolidate this new entity.

(c) Functional and presentation currency

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

(d) Basis of measurement

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.

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(e) Use of estimates and judgments

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

The continuing uncertainty around the outbreak of the novel coronavirus (“COVID-19”) pandemic required the use of judgements and estimates in the preparation of the condensed consolidated interim financial statements for the three months ended December 31, 2020. The future impact of COVID-19 uncertainties could generate, in future reporting periods, a significant impact to the reported amounts of assets, liabilities, revenue and expenses in these and any future financial statements.

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

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

3. Significant accounting policies

During the three months ended December 31, 2020, the accounting policies in these condensed consolidated interim financial statements are the same as those applied in KWESST’s consolidated financial statements as at and for the period ended September 30, 2020.

4. New accounting standards issued but not yet in effect

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

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

- (i) Clarified that the classification of liabilities as current or non-current should only be based on rights that are in place at the *end of the reporting period*.
- (ii) Clarified that classification is unaffected by expectations about whether an entity will exercise its right to defer settlement of a liability; and
- (iii) Made clear that settlement includes transfers to the counterparty of cash, equity instruments, other assets or services that result in extinguishment of the liability.

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

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5. Trade and other receivables

The following table presents trade and other receivables for KWESST:

	December 31, 2020	September 30, 2020
Trade receivables	\$ 127,299	\$ 209,169
Sales tax recoverable	227,566	142,797
Investment tax credits refundable	151,456	127,325
Total	\$ 506,321	\$ 479,291

There was no impairment of trade and other receivables during the quarter ended December 31, 2020 (2019 – \$nil).

6. Property and equipment

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

Cost	Office furniture and equipment					Leasehold improvements	Total property and equipment
	Computer equipment	Computer software	Office furniture and equipment	R&D equipment			
Balance, September 30, 2020	\$ 32,807	\$ 8,145	\$ 81,838	\$ 53,634	\$ 59,090	\$ 235,514	
Additions	3,865	-	3,993	2,007	-	9,864	
Disposals	-	-	-	-	-	-	
Balance at December 31, 2020	\$ 36,672	\$ 8,145	\$ 85,831	\$ 55,641	\$ 59,090	\$ 245,378	

Accumulated depreciation	Office furniture and equipment					Leasehold improvements	Total property and equipment
	Computer equipment	Computer software	Office furniture and equipment	R&D equipment			
Balance, September 30, 2020	\$ 6,062	\$ 7,637	\$ 22,292	\$ 20,837	\$ 4,045	\$ 60,873	
Amortization for 3 months	1,633	273	6,804	2,665	2,396	13,770	
Disposals	-	-	-	-	-	-	
Balance at September 30, 2020	\$ 7,695	\$ 7,910	\$ 29,096	\$ 23,502	\$ 6,441	\$ 74,643	

Carrying value at September 30, 2020	\$ 26,745	\$ 508	\$ 59,546	\$ 32,797	\$ 55,045	\$ 174,641
Carrying value at December 31, 2020	\$ 28,977	\$ 235	\$ 56,735	\$ 32,139	\$ 52,650	\$ 170,735

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7. Right-of-use assets

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

	Offices	Printer	Total right-of-use assets
Balance at September 30, 2020	\$ 517,161	\$ 3,279	\$ 520,440
Additions	-	-	-
Depreciation	(21,682)	(3,279)	(24,961)
Balance at December 31, 2020	\$ 495,479	\$ -	\$ 495,479

8. Intangible assets

The following table presents intangible assets for KWESST:

	Development Costs	Technology Asset	Total
Cost			
Balance at September 30, 2020	\$ 163,230	\$ 481,472	\$ 644,702
Additions	319,452	-	319,452
Balance at December 31, 2020	\$ 482,682	\$ 481,472	\$ 964,154

During the quarter ended December 31, 2020, KWESST capitalized development costs of \$319,452 in connection with a U.S. military contract awarded in December 2020 to be delivered later in fiscal 2021, featuring KWESST's signature Tactical Awareness and Situational Control System ("TASCS").

The technology asset relates to the GhostStep technology acquisition. As this technology has not yet reached commercialization, no amortization charge was recorded for the three months ended December 31, 2020.

9. Accounts payable and accrued liabilities

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

	December 31, 2020	September 30, 2020
Trade payable	\$ 775,654	\$ 493,027
Accrued liabilities	157,161	188,265
Payroll taxes payable	23,409	67,229
Salary and vacation payable	87,005	65,722
Other	-	4,031
Total	\$ 1,043,229	\$ 818,274

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10. Related party transactions

Key management personnel compensation

Key management personnel are those having authority and responsibility for planning, directing and controlling the activities of KWESST directly or indirectly, including any directors (executive and nonexecutive) of KWESST. The key management personnel of KWESST are the executive management team and Board of Directors, who collectively control approximately 34.9% of the issued and outstanding common shares of KWESST at December 31, 2020.

Key management personnel compensation comprised the following:

	Quarter ended September 30, 2020	Quarter ended December 31, 2019
Wages and benefits	\$ 67,723	\$ 35,000
Consulting fees	45,000	46,000
Share-based compensation	140,916	-
Total	\$ 253,639	\$ 81,000

The consulting fees relate to compensation paid to KWESST's Executive Chairman (via his private corporation, DEFSEC Corporation) and the former Chief Financial Officer.

Related party loans

The following table summarizes the related party loans.

	Loans from CEO	Employee loan	Total
Balance, September 30, 2020	\$ 207,092	\$ 11,184	\$ 218,276
Repayment of loans	(10,000)	(11,252)	(21,252)
Accrued interest	2,002	68	2,070
Balance, December 31, 2020	\$ 199,094	\$ -	\$ 199,094

Other related party transactions during the nine months ended December 31, 2020:

- KWESST hired a consulting firm to provide capital markets advisory services. This consulting firm is also a significant shareholder and holds 1,500,000 warrants at December 31, 2020. Total cash and share-based remuneration amounted to \$35,615.

At December 31, 2020 and September 30, 2020, there was no outstanding amount in accounts payable and accrued liabilities due to officers and directors of KWESST.

11. Borrowings

In December 2020, the Canadian Federal Government amended the CEBA Term Loan program to increase the loan amount by \$20,000 to \$60,000. In December 2020, KWESST has increased its

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borrowings accordingly. Additionally, effective January 1, 2021, the outstanding balance of the CEBA Term Loan was automatically converted to a 2-year interest free term loan. The CEBA Term Loan may be repaid at any time without notice or the payment of any penalty. If 75% of the CEBA Term Loan is repaid on or before December 31, 2022, the repayment of the remaining 25% shall be forgiven. If on December 31, 2022, KWESST exercises the option for a 3-year term extension, a 5% annual interest will be applied on the any balance remaining during the extension period.

KWESST initially recorded the loan at fair value, without taking into account the potential forgivable amount.

Additionally, KWESST maintains corporate credit cards for its key employees and a foreign exchange line of credit with Royal Bank of Canada. To provide security, in December 2020, KWESST entered into a cash collateral agreement for \$30,000 and a general security agreement providing a first lien on all assets.

12. Lease obligations

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

The following table presents lease obligations for KWESST:

			Current	Non-current
		Offices	Portion	portion
Balance, September 30, 2020	\$	574,752	\$ 78,358	\$ 496,394
Lease payments (including interest)		(12,783)		
Interest expense		14,895		
Balance at December 31, 2020	\$	576,864	\$ 87,325	\$ 489,539

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

	December 31,	September 30,
	2020	2020
Less than one year	\$ 127,830	\$ 127,830
One to five years	624,162	636,945
Total	\$ 751,992	\$ 764,775

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

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Notes to Unaudited Condensed Consolidated Interim Financial Statements
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13. Share capital and Contributed Surplus

Share capital

Authorized

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

Issued Common Shares

	Number	Amount
Balance, September 30, 2019	18,700,200	\$ 648,508
Issued for converted debt and accrued interest	3,104,486	620,897
Issued in private placement	5,075,000	1,014,948
Outstanding at December 31, 2019	26,879,686	\$ 2,284,353
Balance, September 30, 2020	41,266,176	\$ 9,374,563
Issued for debt settlements	91,626	64,138
Issued for exercise of stock options	334,456	265,344
Outstanding at December 31, 2020	41,692,258	\$ 9,704,045

Contributed Surplus

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

Stock Options

The following is summary of changes in outstanding options since December 31, 2020.

	Number of options	Weighted average exercise price
Options outstanding at September 30, 2020	2,018,714	\$ 0.65
Granted	1,050,000	\$ 0.90
Exercised	(334,356)	\$ 0.59
Cancelled	(250,000)	\$ 0.70
Options outstanding at December 31, 2020	2,484,358	\$ 0.76
Options exercisable at December 31, 2020	1,109,358	\$ 0.71

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The following table summarizes information about stock options outstanding at December 31, 2020:

Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Number exercisable
\$0.47	42,858	2.45	42,858
\$0.50	91,500	0.42	91,500
\$0.65	725,000	4.16	262,500
\$0.70	625,000	4.53	462,500
\$0.75	250,000	4.53	62,500
\$0.97	750,000	4.96	187,500
	2,484,358	4.37	1,109,358

At December 30, 2020, there were 1,667,360 stock options available for grant under KWESST's stock option plan.

For the three months ended December 31, 2020, KWESST recorded stock-based compensation expenses of \$196,185 (2019 – \$Nil). The options granted during the quarter ended December 31, 2020, the per share weighted-average fair value of stock options was \$0.39, using the Black-Scholes option model with the following weighted-average assumptions:

Stock price	\$0.70 to \$0.97
Exercise price	\$0.70 to \$0.97
Volatility	65.82%
Dividend Yield	Nil
Risk-free interest rate	0.29%
Expected life (years)	2.73
Weighted-average fair value per option	\$ 0.39

Stock option grant amended

During the quarter ended December 31, 2020, KWESST amended an investor relations consulting agreement, which resulted in the cancellation of 250,000 options.

Issued Warrants

On December 31, 2020, a warrant holder exercised 250,000 warrants at \$0.50 each; however, the settlement took place early in January 2021 and therefore the issuance of common shares will be recognized then. This was cashless exercise as KWESST owed \$125,000 in annual payment in connection with the GhostStep® Technology acquired in Fiscal 2020.

No other warrant activities took place during the quarter ended December 31, 2020.

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14. Earnings (loss) per share

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

	Three months ended December 31, 2020	Three months ended December 31, 2019
Issued common shares, beginning of period	41,266,176	18,700,200
<i>Effect of shares issued from:</i>		
Issuance for debt settlements	16,931	-
Exercise of options	106,325	-
Conversion of convertible notes, including interest	-	2,067,343
Weighted average number of basic common shares	41,389,432	20,767,543
<i>Dilutive securities:</i>		
Stock options	-	-
Warrants	-	-
Weighted average number of dilutive common shares	41,389,432	20,767,543

At December 30, 2020 and 2019, all the stock options and warrants were anti-dilutive because of KWESST's net loss for both of the above periods.

15. Revenue

The following table presents the key streams of revenue for KWESST:

	Quarter ended December 31, 2020	Quarter ended December 31, 2019
United States	\$ 138,934	\$ -
Canada	7,415	3,741
	\$ 146,349	\$ 3,741

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 December 31, 2020, KWESST's contracted not yet recognized revenue was approximately \$1.1 million, of which 100% of this amount is expected to be recognized over the next six months.

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16. Financial instruments

Fair value of financial instruments

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

Financial risk management

The Company is exposed to a number of financial risks arising through the normal course of business as well as through its financial instruments. The Company's overall business strategies, tolerance of risk and general risk management philosophy are determined by the directors in accordance with prevailing economic and operating conditions.

(a) Interest rate risk

Interest rate risk is the risk that the fair value of cash flows of a financial instrument will fluctuate because of changes in market interest rates. KWESST's related party loans have fixed interest rate terms and therefore KWESST is not exposed to interest rate risk.

(b) Foreign currency risk

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

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

At December 31, 2020, KWESST had the following net US dollar exposure:

	Total USD
Assets	\$ 277,782
Liabilities	(350,360)
Net exposure at December 31, 2020	\$ (72,578)

Impact to profit or loss if 5% movement in the US dollar	\$ (3,629)
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During the quarter ended December 31, 2020, KWESST recorded foreign exchange loss of \$3,385, (2019 – loss of \$41,617).

(c) Credit risk

Credit risk is the risk of financial loss to the Company if a counterparty to a financial instrument fails to meet its contractual obligations. KWESST's credit risk exposure is limited to cash, and trade and other

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receivables. The counterparty for the trade and other receivables is the Canadian government and a U.S. military customer.

(d) Liquidity risk

Liquidity risk is the risk that KWESST will be unable to meet its financial obligations as they become due. KWESST's objective is to ensure that it has sufficient cash to meet its near term obligation when they become due, under both normal and stressed condition, without incurring unacceptable losses or risking reputational damage to KWESST.

A key risk in managing liquidity is the degree of uncertainty in KWESST's cash flows due to its early stage in operations. KWESST's working capital at December 31, 2020 was approximately \$1.4 million and as noted in Note 20, *Subsequent Events*, KWESST raised additional capital via exercises of warrants and options.

17. Supplemental cash flow information

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

	Quarter ended December 31, 2020	Quarter ended December 31, 2019
Trade and other receivables	\$ (27,030)	\$ (164,062)
Prepaid expenses and other	(123,977)	(33,344)
Accounts payable and accrued liabilities	289,094	180,653
Deferred revenue	(7,053)	-
	\$ 131,034	\$ (16,753)

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

- \$64,138 debt settlement via common shares; and
- \$69,387 fair value of options exercised and transferred to share capital from contributed surplus.

18. Commitments and contingencies

Minimum royalties

On November 18, 2019, KWESST entered into a non-exclusive license agreement with a third party for its product named DroneBullet (rebranded as GreyGhost), a drone whose principal function and operation is acting as a projectile to intercept aerial threats using kinetic force. Under this license agreement, KWESST will pay 8% royalty on annual sales of GreyGhost to the third party, subject to the following minimum annual payments.

- \$150,000 for March 31, 2020 to December 31, 2020;
- \$200,000 for January 1, 2021 to December 31, 2021;
- \$300,000 for January 1, 2022 to December 31, 2022;
- \$400,000 for January 1, 2023 to December 31, 2023; and
- \$500,000 for January 1, 2024 to December 31, 2024.

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In accordance with this license agreement, KWESST paid \$150,000 advanced royalty to the third party in 2019. Due to delays in completing a fully functional GreyGhost, the third party delayed its minimum annual royalty payment. In light of this delay, KWESST and the third party are currently renegotiating the contract to amend certain terms, including the timing for the first minimum annual payment. Further, the parties remain committed to complete a fully functional GreyGhost in fiscal 2021.

This agreement will expire on March 31, 2025.

19. Segmented information

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

Geographic information

The following table presents external revenue on a geographic basis:

	Quarter ended December 31, 2020	Quarter ended December 31, 2019
United States	\$ 138,934	\$ -
Canada	7,415	3,741
	\$ 146,349	\$ 3,741

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

Concentration of customers information

For the three months ended December 31, 2020, one customer accounted for the revenue based in the United States.

20. Subsequent events

a) Technology acquisition

On January 18, 2021, KWESST announced its Board of Directors approved the acquisition of a proprietary non-lethal munitions technology system, referred as the Low Energy Cartridge ("LEC") technology, from DEFSEC (a private company owned by KWESST's Executive Chairman), subject to closing conditions including TSX-V's approval.

The purchase consideration consists of:

- 1,000,000 common shares of KWESST, subject to four month hold; and
- 500,000 warrants to purchase KWESST's common shares at \$0.70 each; 25% vesting on the first anniversary of the closing of the LEC Technology acquisition and 25% per annum thereafter.

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Additionally, KWESST will pay 7% royalty on annual sales of the LEC Technology to DEFSEC, net of taxes and duties, up to a maximum of \$10 million, subject to minimum annual royalty payments starting in 2022.

On February 19, 2021, the TSX-V approved the technology acquisition and consented to closing this transaction. KWESST expect to close this transaction by March 31, 2021.

b) Stock option activities

Stock option exercised

Since December 31, 2020, 341,500 options were exercised for total proceeds of \$220,750.

Stock option grant

Since December 31, 2020, KWESST granted 1,152,500 stock options to employees, directors and consultants, with exercise prices ranging from \$1.72 to \$2.28 per share. Each of these options was granted for a term of five years and will vest quarterly over one to two years, with 25% vesting immediately except for 187,500 granted to an investor relations consultant in which the vesting will begin after 3 months.

c) Warrants exercised

Since December 31, 2020, 158,899 warrants were exercised for total proceeds of \$111,229.

d) Unsecured loan

On February 24, 2021, KWESST entered into an unsecured loan agreement with a private fund managed by a KWESST shareholder to borrow \$306,000 for general corporate purposes. The loan is due on demand and bears interest at 0.5% per month. The maturity date for this loan is the earliest of a change of control (as defined in the agreement) and May 25, 2021.