

Condensed Consolidated Interim Financial Statements of
KWESST MICRO SYSTEMS INC.

Three and nine months ended June 30, 2022, and 2021

(Unaudited – Expressed in Canadian dollars)

KWESST MICRO SYSTEMS INC.

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KWESST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Financial Position
At June 30, 2022 and September 30, 2021
(Unaudited)

<i>In Canadian dollars</i>	Notes	June 30, 2022	September 30, 2021
ASSETS			
Cash		\$ 189,587	\$ 2,688,105
Restricted short-term investment		30,000	30,000
Trade and other receivables	5	194,481	699,251
Inventories	6	445,000	90,299
Prepaid expenses and other		280,518	548,042
Current assets		1,139,586	4,055,697
Property and equipment		892,896	903,649
Right-of-use assets		222,652	266,214
Deposit		23,024	21,367
Intangible assets	7	4,244,253	3,470,919
Non-current assets		5,382,825	4,662,149
Total Assets		\$ 6,522,411	\$ 8,717,846
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Accounts payable and accrued liabilities	8 and 9	\$ 2,263,702	\$ 1,127,202
Accrued royalties liability	4	150,000	-
Lease obligations		67,450	32,288
Borrowings	10	1,752,865	-
Current liabilities		4,234,017	1,159,490
Accrued royalties liability	4	1,072,976	1,105,756
Lease obligations		224,410	275,621
Borrowings	10	-	53,251
Non-current liabilities		1,297,386	1,434,628
Total Liabilities		5,531,403	2,594,118
Shareholders' Equity			
Share capital	12(a)	19,165,734	17,215,068
Warrants	12(b)	1,902,055	1,848,389
Contributed surplus	12(c)	3,473,768	2,458,211
Accumulated other comprehensive loss		(28,123)	(8,991)
Accumulated deficit		(23,522,426)	(15,388,949)
Total Shareholders' Equity		991,008	6,123,728
Total Liabilities and Shareholders' Equity		\$ 6,522,411	\$ 8,717,846

See Note 2(a) Going concern and Note 18 Commitments and contingencies.

See accompanying notes to the unaudited 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
Three and nine months ended June 30, 2022 and 2021
(Unaudited)

<i>In Canadian dollars</i>	Notes	Three Months Ended June 30, 2022	Three Months Ended June 30, 2021	Nine Months Ended June 30, 2022	Nine Months Ended June 30, 2021
Revenue	14	\$ 282,432	\$ 521,724	\$ 466,148	\$ 1,115,757
Cost of sales		(238,350)	(315,273)	(405,841)	(718,309)
Gross profit		44,082	206,451	60,307	397,448
Operating expenses	2(f)				
General and administrative		1,322,730	1,236,988	3,410,887	2,909,349
Selling and marketing		851,705	882,261	2,931,460	2,195,647
Research and development, net		350,689	678,622	1,610,445	1,648,711
Total operating expenses		2,525,124	2,797,871	7,952,792	6,753,707
Operating loss		(2,481,042)	(2,591,420)	(7,892,485)	(6,356,259)
Other income and expenses					
Gain on acquisition	4	41,869	-	41,869	-
Net finance costs	15	(184,177)	(27,780)	(304,298)	(60,857)
Foreign exchange gain (loss)		22,901	(9,025)	22,602	(14,189)
Loss on disposals		-	-	(1,165)	-
Total other income and expenses		(119,407)	(36,805)	(240,992)	(75,046)
Net loss		\$ (2,600,449)	\$ (2,628,225)	\$ (8,133,477)	\$ (6,431,305)
Other comprehensive loss:					
<i>Items that are or may be reclassified subsequently to profit or loss:</i>					
Foreign currency translation differences		(34,171)	-	(19,132)	-
Total comprehensive loss		\$ (2,634,620)	\$ (2,628,225)	\$ (8,152,609)	\$ (6,431,305)
Net loss per share					
Basic and diluted		\$ (0.05)	\$ (0.06)	\$ (0.16)	\$ (0.15)
Weighted average number of shares outstanding					
Basic and diluted	13	51,988,774	46,016,645	50,288,043	43,126,552

See accompanying notes to the unaudited condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Changes in Shareholders' Equity
Nine months ended June 30, 2022, and 2021
(Unaudited)
In Canadian dollars

	Notes	Share capital	Contingent shares	Warrants	Contributed surplus	Translation reserve	Deficit	Total Shareholders' Equity
Balance, September 30, 2020		\$ 9,374,563	\$ -	\$ 277,170	\$ 306,708	\$ -	\$ (6,073,577)	\$ 3,884,864
Shares issued to settle debt		63,949	-	-	-	-	-	63,949
Warrants exercised		220,220	-	(102,991)	-	-	-	117,229
Shares and warrants issued on asset acquisition		1,427,000	-	425,000	-	-	-	1,852,000
Shares and warrants issued for cash		3,571,418	-	848,654	-	-	-	4,420,072
Stock options exercised		736,419	-	-	(203,516)	-	-	532,903
Share offering costs		(693,905)	-	-	233,057	-	-	(460,848)
Share-based compensation	12(c)	-	-	-	1,398,881	-	-	1,398,881
Shares for vested RSUs		2,883	-	-	(2,883)	-	-	-
Net loss	12	-	-	-	-	-	(6,431,305)	(6,431,305)
Balance, June 30, 2021		\$ 14,702,547	\$ -	\$ 1,447,833	\$ 1,732,247	\$ -	\$ (12,504,882)	\$ 5,377,745
Balance, September 30, 2021		\$ 17,215,068	\$ -	\$ 1,848,389	\$ 2,458,211	\$ (8,991)	\$ (15,388,949)	\$ 6,123,728
Shares issued to settle debt		19,000	-	-	-	-	-	19,000
Shares and warrants issued on acquisition	4	377,503	83,319	132,000	-	-	-	592,822
Contingent shares converted to common shares	4	83,319	(83,319)	-	-	-	-	-
Warrants exercised		277,098	-	(61,173)	-	-	-	215,925
Warrants expired		-	-	(17,161)	17,161	-	-	-
Share-based compensation	12(c)	-	-	-	1,875,392	-	-	1,875,392
Shares for vested RSUs and PSUs		854,181	-	-	(854,181)	-	-	-
Vested RSUs and PSUs repurchased for withholding taxes		-	-	-	(22,815)	-	-	(22,815)
Shares issued for unsecured loans	10	365,888	-	-	-	-	-	365,888
Share offering costs		(26,323)	-	-	-	-	-	(26,323)
Other comprehensive loss		-	-	-	-	(19,132)	-	(19,132)
Net loss		-	-	-	-	-	(8,133,477)	(8,133,477)
Balance, June 30, 2022		\$ 19,165,734	\$ -	\$ 1,902,055	\$ 3,473,768	\$ (28,123)	\$ (23,522,426)	\$ 991,008

See accompanying notes to the unaudited condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.
Condensed Consolidated Interim Statements of Cash Flows
Nine months ended June 30, 2022, and 2021
(Unaudited)

<i>In Canadian dollars</i>	Notes	Nine months ended June 30, 2022	Nine months ended June 30, 2021
OPERATING ACTIVITIES			
Net loss		\$ (8,133,477)	\$ (6,431,305)
<i>Items not affecting cash:</i>			
Depreciation and amortization		225,308	88,484
Share-based compensation	12(c)	1,875,392	1,398,881
Gain on acquisition	4	(41,869)	-
Net finance costs		304,298	60,857
Loss on disposals		1,165	-
Shares for amended license		-	137,000
Impairment of intangible assets		-	55,376
Changes in non-cash working capital items	17	1,886,747	1,610
Interest paid		(65,316)	(29,132)
Cash used in operating activities		(3,947,752)	(4,718,229)
INVESTING ACTIVITIES			
Additions of property and equipment		(172,158)	(119,909)
Investments in intangible assets	7	(764,067)	-
Recognition of open orders from acquisition	7	159,650	-
Cash acquired on acquisition	4	162,547	-
Deposit for advanced royalties		-	(150,000)
Purchase of restricted short-term investment		-	(30,000)
Cash flows used in investing activities		(614,028)	(299,909)
FINANCING ACTIVITIES			
Proceeds from borrowings	10	2,000,000	326,000
Repayment of borrowings		-	(306,000)
Payments of deferred financing fees		(74,055)	-
Payments of share offering costs		(26,323)	(460,848)
Repayments to related party loans		-	(218,276)
Repayments of lease obligations		(29,470)	(34,576)
Proceeds from the issuance of common shares		-	4,420,072
Proceeds from exercise of warrants		215,925	117,229
Proceeds from exercise of stock options		-	532,903
Repurchase of vested RSUs and PSUs for withholding taxes		(22,815)	-
Cash flows provided by financing activities		2,063,262	4,376,504
Net change in cash during the period		(2,498,518)	(641,634)
Cash, beginning of period		2,688,105	3,073,760
Cash, end of period		\$ 189,587	\$ 2,432,126

See Note 17 Supplemental cash flow information.

See accompanying notes to the unaudited condensed consolidated interim financial statements.

KWESST MICRO SYSTEMS INC.

Notes to Unaudited Condensed Consolidated Interim Financial Statements
Three and nine months ended June 30, 2022, and 2021
(Expressed in Canadian dollars, except share amounts)

1. 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 and on the OTCQB® Venture Market under the stock symbol of KWEMF and on the Frankfurt Stock Exchange under the stock symbol of 62U.

2. Basis of preparation

(a) *Going concern*

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

As an early-stage company, 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 approximately \$8.1 million net loss and negative operating cash flows of approximately \$3.9 million for the nine months period ended June 30, 2022 (nine months ended June 2021 - \$6.4 million net loss and negative operating cash flows of \$4.7 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 and the ability to raise additional debt or equity financing, as required. There are various risks and uncertainties affecting our future financial position and its 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 COVID-19 pandemic.

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 condensed consolidated interim 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.

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Notes to Unaudited Condensed Consolidated Interim Financial Statements
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(b) Statement of compliance

These unaudited condensed consolidated interim financial statements have been prepared in accordance with IAS 34, Interim Financial Reporting, (“IAS 34”) as issued by the International Accounting Standards Board (“IASB”). They do not include all the information required for a complete set of financial statements prepared in accordance with International Financial Reporting Standards (“IFRS”) and should be read in conjunction with our annual consolidated financial statements for the year ended September 30, 2021. However, selected explanatory notes are included to explain events and transactions that are significant to an understanding of the changes in our financial position and performance since the last annual consolidated financial statements as at and for the year ended September 30, 2021.

These unaudited condensed consolidated interim financial statements were authorized for issue by our Board of Directors on August 11, 2022.

(c) Basis of consolidation

These unaudited condensed consolidated interim 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.

At June 30, 2022, we have the following wholly-owned subsidiaries:

	Location	Equity %
KWESST Inc.	Ottawa, Canada	100%
2720178 Ontario Inc.	Bowmanville, Canada	100%
Police Ordnance Company Inc.	Bowmanville, 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

These financial statements are presented in Canadian dollars (“CAD”), KWESST’s functional currency 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) Comparative figures

For the year ended September 30, 2021, we changed the presentation of our expenses in the consolidated statements of net loss and comprehensive loss from by nature to by function. We made this change in presentation to provide more relevant financial information to facilitate peer benchmarking, particularly with

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Notes to Unaudited Condensed Consolidated Interim Financial Statements

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peers in the United States. As a result, our operating expenses for the three and nine months ended June 30, 2022 and 2021 are now presented as follows: general and administration (“G&A”), selling and marketing (“S&M”), and research and development, net (“R&D”).

(g) Use of estimates and judgments

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

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 are the same as disclosed in Note 2(g) of the consolidated financial statements for the year ended September 30, 2021, with the addition of the following:

- Note 4 – *acquisition of Police Ordnance*: whether the purchase price allocation applied to the consideration transferred and assumptions used as inputs in determining the fair value of net assets acquired is reasonable.
- Note 10 – *unsecured loans*: whether the estimated market discount rate used to estimate the fair value of the unsecured loans is reasonable.

Estimates

Information about assumptions and estimation uncertainties at June 30, 2022 that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next financial year are the same as disclosed in Note 2(g) of the consolidated financial statements for the year ended September 30, 2021.

COVID-19 Uncertainties

While COVID-19 has not had a material impact to our business to date, the following is a summary of what we believe may impact our future business given the persistency of COVID-19: disruptions to business operations resulting from quarantines of employees, customers, manufacturers and other third-party service providers in areas affected by the outbreak; disruptions to business operations resulting from travel restrictions, including travel to industry tradeshows; and uncertainty around the duration of the virus' impact.

Despite the global vaccination efforts underway, the extent to which COVID-19 could impact our operations, financial condition, results of operations, and cash flows is highly uncertain and cannot be predicted. Negative financial results, uncertainties in the market, and a tightening of credit markets, caused by COVID-19, or a recession, could have a material adverse effect on our liquidity and ability to obtain financing in the future.

3. Significant accounting policies

During the three and nine months ended June 30, 2022, the accounting policies in these condensed consolidated interim financial statements are the same as those applied in our consolidated financial statements as at and for the year ended September 30, 2021.

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4. Acquisitions

Acquisition in Current Fiscal Year

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 ARWEN™ product 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.

Consideration Transferred:

The purchase consideration comprised of the following:

	Number	Fair Value
Common shares	277,576	\$ 377,503
Warrants	200,000	\$ 132,000
Contingent shares	61,264	\$ 83,319
Total fair value purchase consideration		\$ 592,822

The warrants are exercisable at \$1.72 each and will expire on December 15, 2024.

We issued the 61,264 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, 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

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Net Assets Acquired:

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

Total purchase consideration at fair value	\$	592,822
<i>Police Ordnance's net assets:</i>		
Cash		162,547
Trade and other receivables		104,432
Inventories		343,655
Intangible assets		165,596
Accounts payable and accrued liabilities		82,963
Corporate tax liability		32,338
Borrowings		26,238
Net assets at fair value	\$	634,691
Gain on acquisition	\$	41,869

The fair value of inventories in the above allocation continues to be under review due to the need for additional information related to certain specialized raw materials. In addition, we are completing our identification and assessment of intangible assets acquired in connection with the business combination, if any. This will be finalized by September 30, 2022.

Impact on KWESST's Results of Operations:

The results of operations of Police Ordnance are included in these unaudited condensed consolidated interim statements of net loss and comprehensive loss from December 16, 2021. If the acquisition had occurred on October 1, 2021, management estimates that Police Ordnance would have contributed approximately \$341,500 and \$623,800 of revenue and approximately \$51,600 and \$2,500 of net profit to KWESST's operating results for the three and nine months ended June 30, 2022, respectively. In determining these amounts, management has 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.

KWESST incurred acquisition-related costs of \$2,304 which are recorded as an expense in the unaudited condensed consolidated interim statements of net loss and comprehensive loss as part of general and administrative expenses. Share offering costs of \$4,150 in relation to the acquisition are recorded against share capital on the unaudited condensed consolidated interim statements of financial position.

Acquisition in Prior Fiscal Year

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*.

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However, we obtained approval from over 51% disinterested shareholders as well as from the TSX-V prior to closing the acquisition.

The purchase consideration consisted of:

- 1,000,000 common shares of KWESST; and
- 500,000 warrants to purchase our common shares at \$0.70 each; 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 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 allocation was determined as follows:

	Number	Fair Value
Common shares	1,000,000	\$ 1,290,000
Warrants	500,000	\$ 425,000
Minimum royalty payments		\$ 1,191,219
Total		\$ 2,906,219

Identifiable intangible assets

Technology asset	\$ 2,906,219
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We estimated the fair value as follows:

- *Common shares*: based on KWESST’s closing stock price on April 29, 2021.

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- *Warrants*: based on using the Black Scholes option model with the following key inputs: a) exercise price of \$0.70, underlying stock price of \$1.29, risk free rate of 0.48%, expected life of three years, and expected volatility of 80%.
- *Minimum royalty payments*: based on the income approach, specifically discounted cash flows, using a discount rate of 13.7% per annum.

During the three and nine months ended June 30, 2022, we recorded \$40,393 and \$113,899, respectively, of accretion cost relating to the discounted minimum royalty payments, which is included in net finance costs in the condensed consolidated interim statement of net loss and comprehensive loss (three and nine months ended June 30, 2021 - \$25,567 and \$25,567, respectively). As at June 30, 2022, \$1,222,976 of accrued royalties liability was outstanding (2021 - \$1,105,756).

5. Trade and other receivables

The following table presents trade and other receivables for KWESST:

	June 30, 2022	September 30, 2021
Trade receivables	\$ 94,083	\$ -
Unbilled revenue	-	308,728
Sales tax recoverable	100,398	183,761
Investment tax credits refundable	-	206,762
Total	\$ 194,481	\$ 699,251

There was no impairment of trade and other receivables during the three and nine months ended June 30, 2022 (2021 – \$nil).

The following table presents changes in unbilled receivables:

	June 30, 2022	September 30, 2021
Balance, beginning of period	\$ 308,728	\$ -
Revenue in excess of billings, net of amounts transferred to trade receivables	-	308,728
Transferred to trade receivables	(308,728)	-
Balance, end of period	\$ -	\$ 308,728
Current	\$ -	\$ 308,728
Non-current	\$ -	\$ -

6. Inventories

The following table presents a breakdown of inventories:

	June 30, 2022	September 30, 2021
Finished goods	\$ 66,594	\$ -
Work-in-progress	18,843	-
Raw materials	359,563	90,299
Total	\$ 445,000	\$ 90,299

There was no impairment of inventories during the three and nine months ended June 30, 2022 (2021 – \$nil).

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Notes to Unaudited Condensed Consolidated Interim Financial Statements
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7. Intangible assets

The following table presents intangible assets for KWESST:

Cost	Phantom™ System	PARA OPS™ System ⁽¹⁾	Patent	ARWEN™	Total
Balance at September 30, 2021	\$ 564,700	\$ 2,906,219	\$ -	\$ -	\$ 3,470,919
Additions	365,947	372,658	28,783	-	767,388
Acquisition (Note 4)	-	-	-	165,596	165,596
Recognition of open orders ⁽²⁾	-	-	-	(159,650)	(159,650)
Balance at June 30, 2022	\$ 930,647	\$ 3,278,877	\$ 28,783	\$ 5,946	\$ 4,244,253

(1) In January 2022, we have branded the technology known as the Low Energy Cartridge system as PARA OPS™ system.

(2) This represents the open customer orders at the time of the acquisition measured at fair value, which were subsequently delivered to customers during the period.

The balance at June 30, 2022 for Phantom™ and PARA OPS™ represents the acquired technology asset (i.e. intellectual properties), coupled with additional capitalized development costs. As both product lines have not yet reached commercialization, no amortization charge was recorded for the three and nine months ended June 30, 2022 (2021 - \$nil). The patent relates to the PARA OPS™ system. Management anticipates the estimated useful life to be five years for both technology assets subsequent to the expected commercialization date and the estimated useful life of the patent will be determined subsequent to the approval of the patent.

For the three and nine months ended June 30, 2022, management concluded there was no impairment on the intangible assets (three and nine months ended June 30, 2021 – \$nil and \$55,376, respectively).

8. Accounts payable and accrued liabilities

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

	June 30, 2022	September 30, 2021
Trade payable	\$ 1,354,235	\$ 620,041
Accrued liabilities	661,426	384,239
Salary and vacation payable	248,041	122,922
Total	\$ 2,263,702	\$ 1,127,202

9. Related party transactions

In November 2019, KWESST hired SageGuild LLC to assist us in promoting our product offerings in the United States. From January 28, 2021 to June 24, 2022, the CEO and sole shareholder of SageGuild LLC agreed to serve as director of KWESST Defense Systems U.S. Inc. and as a result SageGuild LLC was a related party to KWESST for this period. The total cash and share-based remuneration amounted to \$81,761 and \$251,809 for the three and nine months ended June 30, 2022, respectively (three and nine months ended June 30, 2021: \$111,269 and \$226,797, respectively). Except for the cash consideration recorded at the exchange amount, the share-based compensation was recorded at fair value.

At June 30, 2022, \$90,758 (September 30, 2021 - \$23,187) was owed to directors and officers for business expense reimbursements and wages, which was included in accounts payable and accrued liabilities. Additionally, \$74,000 of borrowings were owed to directors and officers at June 30, 2022 for their participation in the Unsecured Loans financing (see Note 10).

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10. Borrowings

There were no changes to KWESST's RBC Credit Facility since September 30, 2021, which consists of a \$30,000 corporate credit card program collateralized by the short-term investment.

The following is a reconciliation of borrowings since September 30, 2021:

	CEBA Term Loan	Unsecured Loans	Total
Balance, September 30, 2021	\$ 53,251	\$ -	\$ 53,251
Assumed from acquisition (Note 4)	26,238	-	26,238
Issuance at fair value	-	1,634,112	1,634,112
Deferred financing fees	-	(74,055)	(74,055)
Net borrowings	79,489	1,560,057	1,639,546
Accrued interest and accretion expense	5,818	162,652	168,470
Interest paid	-	(55,151)	(55,151)
Balance, June 30, 2022	\$ 85,307	\$ 1,667,558	\$ 1,752,865
Current	\$ 85,307	\$ 1,667,558	\$ 1,752,865
Non-current	-	-	-
Total	\$ 85,307	\$ 1,667,558	\$ 1,752,865

On March 11, 2022, we closed a non-secured 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 "Unsecured Loans"). Certain directors and officers participated in this financing for an aggregate amount of \$74,000. The Unsecured 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 Unsecured 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 Unsecured Loans, we issued an aggregate of 1,000,000 bonus common shares to the lenders. These common shares were issued pursuant to prospectus exemptions of applicable securities laws and therefore subject to a four-month plus one day trading restriction.

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 Unsecured Loans, we used the income approach and estimated a market discount rate of 22% to discount the future cash flows of the Unsecured Loans resulting in an estimated fair value of \$1,634,112. Accordingly, we allocated \$1,634,112 of the \$2,000,000 to Unsecured 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 Unsecured Loans as a financing cost and the share offering costs were recognized as a reduction to common shares.

As the Unsecured Loans mature in April 2023, we presented these as current borrowings in the consolidated financial position.

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11. Contract liabilities

The following is a reconciliation of contract liabilities since September 30, 2021:

	Contract liabilities
Balance, September 30, 2021	\$ -
Additions	300,340
Revenue recognized	(300,340)
Balance, June 30, 2022	\$ -

12. Share capital and Contributed Surplus

a) Share capital

Authorized

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

Issued Common Shares

The following is a summary of changes in outstanding common shares since September 30, 2021:

	Number	Amount
Balance at September 30, 2021	48,965,631	\$ 17,215,068
Issued for acquisition (Note 4)	277,576	\$ 377,503
Issued for conversion of contingent shares (Note 4)	61,264	\$ 83,319
Issued for debt settlements	10,000	\$ 19,000
Issued for exercise of warrants	1,330,000	\$ 277,098
Issued for conversion of share units	542,636	\$ 854,181
Issued for bonus shares relating to borrowings (Note 10)	1,000,000	\$ 365,888
Less: share offering costs for the period		\$ (26,323)
Balance at June 30, 2022	52,187,107	\$ 19,165,734

Refer to Note 20 (a) Subsequent Event for share issuances subsequent to June 30, 2022.

b) Warrants

The following is a summary of changes in outstanding warrants since September 30, 2021:

	Number of warrants	Weighted average exercise price
Outstanding at September 30, 2021	13,901,640	\$ 0.74
Issued (Note 4)	200,000	\$ 1.72
Exercised	(1,330,000)	\$ 0.26
Expired	(84,622)	\$ 0.45
Outstanding at June 30, 2022	12,687,018	\$ 0.81
Exercisable at June 30, 2022	12,062,018	\$ 0.92

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The following table provides additional information on the total outstanding warrants at June 30, 2022:

	Number outstanding	Fair value ⁽¹⁾	Expiry Date
<i>Founders' warrants:</i>			
Exercise price of \$0.20	5,520,000	\$ 1,013	January 1, 2024
Exercise price of \$0.20	1,900,000	\$ 18,865	June 14, 2024
<i>GhostStep's warrants:</i>			
Exercise price of \$0.50	250,000	\$ 60,000	January 15, 2023
<i>April 2021 equity financing:</i>			
Exercise price of \$1.75	3,274,657	\$ 785,918	April 29, 2023
Exercise price of \$1.75	40,000	\$ 9,600	August 25, 2023
<i>LEC's warrants:</i>			
Exercise price of \$0.70	500,000	\$ 425,000	April 29, 2026
<i>September 2021 equity financing:</i>			
Exercise price of \$2.35	750,000	\$ 390,000	September 16, 2023
<i>Broker warrants:</i>			
Exercise price of \$0.70	69,862	\$ 14,259	July 9, 2022
Exercise price of \$1.75	137,499	\$ 33,000	April 29, 2023
Exercise price of \$2.00	45,000	\$ 32,400	September 16, 2023
<i>Acquisition of Police Ordinance (Note 4):</i>			
Exercise price of \$1.72	200,000	\$ 132,000	December 15, 2024
	12,687,018	\$ 1,902,055	

(1) Fair value is calculated based on the grant date fair value and number outstanding at June 30, 2022 and therefore it does not represent the fair value at June 30, 2022.

The fair value for the warrants issued during the nine months ended June 30, 2022, was determined using the Black-Scholes option model and key inputs:

	Acquisition of POC
Exercise Price	\$ 1.72
Stock price	\$ 1.36
Volatility	84.7%
Dividend Yield	Nil
Risk-free interest rate	1.04%
Expected life	3
Weighted average fair value per warrant	\$ 0.66

Refer to Note 20 (a) Subsequent Event for warrants issued subsequent to June 30, 2022.

c) Contributed Surplus

Share-based compensation

For the three and nine months ended June 30, 2022, KWESST recorded stock-based compensation expenses of \$524,931 and \$1,875,392, respectively (2021: \$520,423 and \$1,398,881, respectively).

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(i) Stock Options

The following is summary of changes in outstanding options since September 30, 2021.

	Number of options	Weighted average exercise price
Outstanding at September 30, 2021	4,167,516	\$ 1.37
Granted	365,000	1.64
Forfeited	(322,813)	1.65
Outstanding at June 30, 2022	4,209,703	\$ 1.37
Options exercisable at June 30, 2022	3,242,703	\$ 1.28

At June 30, 2022, there were 981,254 stock options available for grant under KWESST's LTIP.

For the options granted during the nine months ended June 30, 2022, the per share weighted-average fair value of stock options was \$0.89 using the Black-Scholes option model with the following weighted-average assumptions:

Stock price	\$1.24 to \$1.81
Exercise price	\$1.24 to \$1.81
Volatility	85.21%
Dividend yield	Nil
Risk-free interest rate	1.15%
Expected life (years)	3.00
Weighted-average fair value per option	\$ 0.89

Amended Stock option grants

There were no amended stock option grants during the nine months ended June 30, 2022.

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

(ii) Share Units

The following is summary of changes in share units since September 30, 2021.

	RSUs	PSUs	SARs	Total
Outstanding at September 30, 2021	1,139,072	200,000	150,000	1,489,072
Granted	750,784	1,256,000	36,000	2,042,784
Vested and converted to common shares	(356,036)	(186,600)	-	(542,636)
Vested and repurchased for withholding taxes	(5,846)	(17,400)	-	(23,246)
Forfeited	-	(420,000)	-	(420,000)
Outstanding at June 30, 2022	1,527,974	832,000	186,000	2,545,974

At June 30, 2022, there were 1,105,193 Share Units available for grant under KWESST's LTIP.

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13. 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 condensed consolidated interim statements of net loss and comprehensive loss:

	Three months ended June 30, 2022	Three months ended June 30, 2021	Nine months ended June 30, 2022	Nine months ended June 30, 2021
Issued common shares, beginning of period	51,484,343	42,507,387	48,965,631	41,266,176
Weighted average effect of shares issued from:				
Acquisition of Police Ordinance (Note 4)	-	-	200,304	-
Exercise of options	-	54,816	-	484,936
Exercise of warrants	160,000	-	543,241	253,502
Debt settlements	-	-	9,084	66,364
Conversion of stock units	297,462	1,954	157,229	499
Conversion of contingent shares (Note 4)	46,969	-	15,484	-
Issuance of bonus shares (Note 10)	-	-	397,070	-
Private placements	-	2,460,310	-	803,061
Asset acquisitions	-	888,667	-	227,106
Amended license	-	103,511	-	24,908
Weighted average number of basic common shares	51,988,774	46,016,645	50,288,043	43,126,552
<i>Dilutive securities:</i>				
Stock options	-	-	-	-
Warrants	-	-	-	-
Weighted average number of dilutive common shares	51,988,774	46,016,645	50,288,043	43,126,552

At June 30, 2022 and 2021, all dilutive securities were anti-dilutive because of KWESST's net loss for the above periods.

14. Revenue

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

	Three months ended June 30, 2022	Three months ended June 30, 2021	Nine months ended June 30, 2022	Nine months ended June 30, 2021
Major products / service lines				
Digitization	\$ 157,900	\$ 497,792	\$ 314,515	\$ 1,080,933
ARWEN™	100,684	-	111,176	-
Training and services	23,495	-	39,169	-
Other	353	23,932	1,288	34,824
	\$ 282,432	\$ 521,724	\$ 466,148	\$ 1,115,757
Primary geographical markets				
United States	\$ 27,607	\$ 497,252	\$ 48,658	\$ 1,080,393
Canada	254,825	24,472	417,490	35,364
	\$ 282,432	\$ 521,724	\$ 466,148	\$ 1,115,757
Timing of revenue recognition				
Products and services transferred over time	\$ 181,395	\$ 497,252	\$ 353,684	\$ 1,080,393
Products transferred at a point in time	101,037	24,472	112,464	35,364
	\$ 282,432	\$ 521,724	\$ 466,148	\$ 1,115,757

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At June 30, 2022, our total contracted not yet recognized revenue was \$nil (2021 - \$146,542).

For the three and nine months ended June 30, 2022, one customer accounted for 55.91% and 63.90% of the total revenue (2021 – one customer accounted for 95.31% and 96.83%, respectively).

15. Net finance costs

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

	Three months ended June 30, 2022	Three months ended June 30, 2021	Nine months ended June 30, 2022	Nine months ended June 30, 2021
Interest expense from:				
Borrowings (interest and accretion expense)	\$ 134,563	\$ 4,666	\$ 162,652	\$ 12,336
Accrued royalties liability - accretion expense	40,393	25,567	113,899	25,567
Lease obligations	7,562	(2,891)	23,590	25,916
Other	2,709	1,042	7,668	3,784
Total interest expense	185,227	28,384	307,809	67,603
Interest income	(1,050)	(604)	(3,511)	(6,746)
Net finance costs	\$ 184,177	\$ 27,780	\$ 304,298	\$ 60,857

16. Financial instruments

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 philosophy are determined by the directors in accordance with prevailing economic and operating conditions.

For the three and nine months ended June 30, 2022, there were no material changes to KWESST's financial risks as disclosed in Note 22 of the audited consolidated financial statements for the year ended September 30, 2021.

At June 30, 2022, our contractual obligations were as follows:

Payment due:	Total	Within 1 Year	1 to 3 years	3 to 5 years
Minimum royalty commitments	\$ 2,500,000	\$ 150,000	\$ 350,000	\$ 2,000,000
Borrowings	2,090,000	2,090,000	-	-
Accounts payable and accrued liabilities	2,263,702	2,263,702	-	-
Lease obligations	351,000	93,600	187,200	70,200
Other commitments	12,886	12,886	-	-
Short-term rental obligations	10,574	10,574	-	-
Total contractual obligations	\$ 7,228,162	\$ 4,620,762	\$ 537,200	\$ 2,070,200

At June 30, 2022, we had negative \$3,094,431 (September 30, 2021 - positive \$2,896,207) in working capital (current assets less current liabilities).

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17. Supplemental cash flow information

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

	Nine months ended June 30, 2022	Nine months ended June 30, 2021
Trade and other receivables	\$ 609,202	\$ 23,580
Inventories	(11,046)	(442,074)
Prepaid expenses and other	386,904	36,979
Accounts payable and accrued liabilities	934,025	(876,121)
Contract liabilities	-	(7,053)
Corporate taxes payable	(32,338)	-
Deposits	-	150,000
Accrued royalties liability	-	1,116,299
	\$ 1,886,747	\$ 1,610

The following is a summary of non-cash items that were excluded from the Statements of Cash Flows for the nine months ended June 30, 2022:

- \$83,319 fair value of 61,264 contingent shares settled via common shares;
- \$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.

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

- \$63,949 debt settlement via common shares;
- \$125,000 for 250,000 exercised warrants in connection with the GhostStep™ 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 PARA OPS™ system;
- \$137,000 fair value of common shares issued for the amended and restated license agreement with AerialX; and
- \$169,832 share offering costs relating to the Broker Compensation Options.

18. Commitments and contingencies

There was no significant change to the commitments and contingencies as disclosed in Note 26 of the audited consolidated financial statements for the year ended September 30, 2021.

19. Segmented information

Our Executive Chairman has been identified as the chief operating decision maker. The Executive Chairman evaluates our performance 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 June 30, 2022, and 2021, all of KWESST's property and equipment are located in Canada, including the right-of-use assets.

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20. Subsequent events

a) Non-brokered private placement

On July 14, 2022, we closed a non-brokered private placement, resulting in the issuance of 1,600,000 units of KWESST (“July 2022 Units”), at a price of \$0.215 per July 2022 Unit (the “Issue Price”), for aggregate gross proceeds of \$344,000 (the “July 2022 Offering”).

Each July 2022 Unit is comprised of one common share and one-half common share purchase warrant (the “Warrants”). Each Warrant entitles its holder to acquire one additional common share of KWESST at a price of \$0.285 for a period of 24 months from the closing date. Accordingly, we issued 800,000 Warrants under the July 2022 Offering. There was no finder fee paid in this private placement.

Certain of our directors and officers (the “Insiders”) purchased 406,975 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.

All securities issued in connection with the July 2022 Offering are subject to a statutory hold period in Canada expiring four (4) months and one (1) day from the closing of the Offering. We received final acceptance by the TSX Venture Exchange.