


# POET

## TECHNOLOGIES INC.

Unaudited Consolidated
Financial Statements
9-months ended September 30, 2014

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# NOTICE TO SHAREHOLDERS
# FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2014
**(Unaudited and Expressed in US Dollars)**

# POET TECHNOLOGIES INC.

Auditors' involvement

The auditors of POET Technologies Inc. have not performed a review of the condensed unaudited consolidated financial statements for the three and nine months ended September 30, 2014 and September 30, 2013.

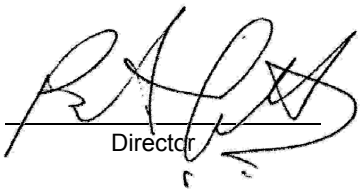
**POET TECHNOLOGIES INC.**

**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**
**(Expressed in US Dollars)**

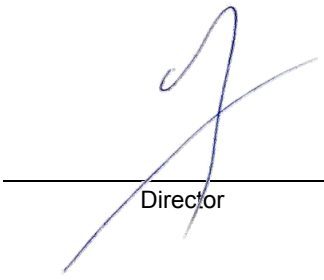
| | September 30, 2014 | (Audited) December 31, 2013 |
|---|---|---|
| **Assets** | | |
| Current | | |
| Cash | **$ 12,281,016** | $ 3,260,967 |
| Prepaids and other current assets | **78,501** | 267,012 |
| Marketable securities (Note 4) | **-** | 397 |
| | **12,359,517** | 3,528,376 |
| Property and equipment (Note 5) | **1,099,643** | 903,792 |
| Patents and licenses (Note 6 and 19) | **182,451** | 125,676 |
| | **$ 13,641,611** | $ 4,557,844 |
| **Liabilities** | | |
| Current | | |
| Accounts payable and accrued liabilities (Notes 7) | **$ 617,865** | $ 256,027 |
| | **617,865** | 256,027 |
| **Shareholders' Equity** | | |
| Share capital (Note 8(b)) | **57,600,142** | 42,911,455 |
| Warrants (Note 9) | **8,739,061** | 8,135,590 |
| Contributed surplus (Note 10) | **23,085,295** | 20,261,067 |
| Accumulated other comprehensive income | **(249,579)** | (11,593) |
| Deficit (Note 19) | **(76,151,173)** | (66,994,702) |
| | **13,023,746** | 4,301,817 |
| | **$ 13,641,611** | $ 4,557,844 |

Commitments and contingencies (Note 12)

On behalf of the Board of Directors



Director



Director

**CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT**
**(Expressed in US Dollars)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| Costs and expenses (Note 17) | | | | |
| General and administration | **3,769,991** | 1,832,563 | **7,603,746** | 4,853,978 |
| Research and development | **627,494** | 532,169 | **1,722,557** | 1,291,757 |
| | **4,397,485** | 2,364,732 | **9,326,303** | 6,145,735 |
| Loss before the following | **(4,397,485)** | (2,364,732) | **(9,326,303)** | (6,145,735) |
| Other income (Note 2) | **-** | 84,628 | **169,832** | 261,984 |
| Net loss | **(4,397,485)** | (2,280,104) | **(9,156,471)** | (5,883,751) |
| Deficit, beginning of period | **(71,753,688)** | (62,752,692) | **(66,994,702)** | (59,149,045) |
| Net loss | **(4,397,485)** | (2,280,104) | **(9,156,471)** | (5,883,751) |
| Deficit, end of period | **$(76,151,173)** | $(65,032,796) | **$(76,151,173)** | $(65,032,796) |
| Basic and diluted loss per share (Note 11) | **$ (0.03)** | $ (0.02) | **$ (0.06)** | $ (0.05) |

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**
**(Expressed in US Dollars)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| Net loss | **$ (4,397,485)** | $ (2,280,104) | **$ (9,156,471)** | $ (5,883,751) |
| Other comprehensive (loss) income - net of income taxes | | | | |
| Exchange differences on translating foreign operations | **291,200** | 66,457 | **(237,986)** | (169,695) |
| Comprehensive loss | **$ (4,106,285)** | $ (2,213,647) | **$ (9,394,457)** | $ (6,053,446) |

**POET TECHNOLOGIES INC.**
**(Expressed in US Dollars)**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**
(Unaudited)

| **For the Nine Months Ended September 30,** | **2014** | 2013 |
|---|---|---|
| **Share Capital** | | |
| Beginning balance | $ 42,911,455 | $ 40,225,401 |
| Shares issued for reduction of license fee | 1,439,898 | - |
| Funds from the exercise of warrants and compensation warrants | 7,704,441 | 37,111 |
| Fair value of warrants and compensation warrants exercised | 3,542,730 | 23,387 |
| Funds from the exercise of stock options | 886,093 | 148,034 |
| Fair value of stock options exercised | 748,193 | 118,558 |
| Funds from private placements | 4,546,000 | 7,189,200 |
| Fair value of warrants and compensation warrants issued | (4,146,957) | (4,308,292) |
| Share issue costs | - | (529,222) |
| Warrant exercise incentive | (31,711) | - |
| September 30, | 57,600,142 | 42,904,177 |
| **Warrants** | | |
| Beginning balance | 8,135,590 | 3,850,685 |
| Fair value of warrants and compensation warrants issued | 4,146,957 | 4,308,292 |
| Fair value of warrants and compensation warrants exercised | (3,542,730) | (23,387) |
| Fair value of expired warrants | (756) | - |
| September 30, | 8,739,061 | 8,135,590 |
| **Contributed Surplus** | | |
| Beginning balance | 20,261,067 | 16,361,282 |
| Stock-based compensation | 3,571,665 | 3,060,448 |
| Fair value of stock options exercised | (748,193) | (118,558) |
| Fair value of expired warrants | 756 | - |
| September 30, | 23,085,295 | 19,303,172 |
| **Accumulated Other comprehensive income** | | |
| Beginning balance | (11,593) | 243,829 |
| Other comprehensive (loss) income attributable to common shareholders | (237,986) | (169,695) |
| September 30, | (249,579) | 74,134 |
| **Deficit** | | |
| Beginning balance | (66,994,702) | (59,149,045) |
| Net loss | (9,156,471) | (5,883,751) |
| September 30, | (76,151,173) | (65,032,796) |
| **Total shareholders' equity** | $ 13,023,746 | $ 5,384,277 |

**POET TECHNOLOGIES INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Expressed in US Dollars)**

| **For the Nine Months Ended September 30,** | **2014** | 2013 |
|---|---|---|
| CASH (USED IN) PROVIDED BY: | | |
| OPERATING ACTIVITIES | | |
| Net loss | **$ (9,156,471)** | $ (5,883,751) |
| Adjustments for: | | |
| Depreciation of property and equipment | **152,710** | 36,157 |
| Amortization of patents and licenses | **14,023** | 9,598 |
| Shares issued for reduction of license fee (Note 18) | **1,439,898** | - |
| Product warranty | **-** | 74,101 |
| Stock-based compensation (Note 10) | **3,571,665** | 3,060,448 |
| | **(3,978,175)** | (2,703,447) |
| Net change in non-cash working capital accounts: | | |
| Accounts and other receivable | **-** | (180,762) |
| Prepaid and other current assets | **188,908** | 158,273 |
| Accounts payable and accrued liabilities | **361,838** | 17,911 |
| Cash flow from operating activities | **(3,427,429)** | (2,708,025) |
| INVESTING ACTIVITIES | | |
| Construction in progress | **(271,160)** | (481,010) |
| Purchase of property and equipment | **(77,401)** | (419,226) |
| Purchase of patents and licenses | **(70,798)** | (62,923) |
| Cash flow from investing activities | **(419,359)** | (963,159) |
| FINANCING ACTIVITIES | | |
| Issue of common shares for cash, net of issue costs | **13,104,823** | 6,845,023 |
| Cash flow from financing activities | **13,104,823** | 6,845,023 |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | **(237,986)** | (169,695) |
| NET CHANGE IN CASH | **9,020,049** | 3,004,144 |
| CASH AND CASH EQUIVALENT, beginning of period | **3,260,967** | 1,435,762 |
| CASH AND CASH EQUIVALENT, end of period | **$ 12,281,016** | $ 4,439,906 |

## 1. DESCRIPTION OF BUSINESS

POET Technologies Inc. is incorporated in the Province of Ontario. POET Technologies Inc. and ODIS Inc. ("ODIS"), a subsidiary of Opel Solar Inc., (collectively, the "Company") develops and markets optical laser and infrared detection using planar opto electronic technology ("POET"). Opel Solar Inc. is a wholly owned subsidiary of POET Technologies Inc. The Company continues to develop the technology to produce a monolithic, integrated opto electronic microchip. The Company's head office is located at 121 Richmond Street West, Suite 501, Toronto, Ontario, Canada M5H 2K1. These condensed unaudited consolidated financial statements of the Company were approved Board of Directors of the Company on November 12, 2014.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These condensed unaudited consolidated financial statements of the Company and its subsidiaries were prepared in accordance with International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB").

These condensed unaudited interim consolidated financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the consolidated audited financial statements for the year ended December 31, 2013.

The preparation of financial statements in accordance with IAS 34 requires the use of certain critical accounting estimates. It also requires management to exercise judgment in applying the Company's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed below:

**Basis of presentation**
These consolidated financial statements include the accounts of POET Technologies Inc. and its subsidiaries. All intercompany balances and transactions have been eliminated on consolidation.

**Foreign currency translation**
These consolidated financial statements are presented in U.S. dollars ("USD"), which is the Company's presentation currency.

Items included in the financial statements of each of the Company's subsidiaries are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities not denominated in the functional currency of an entity are recognized in the statement of operations and deficit.

Assets and liabilities of entities with functional currencies other than USD are translated into the presentation currency at the year end rates of exchange, and the results of their operations are translated at average rates of exchange for the year. The resulting translation adjustments are included in accumulated other comprehensive income in shareholders' equity. Additionally, foreign exchange gains and losses related to certain intercompany loans that are permanent in nature are included in accumulated other comprehensive income.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

**Financial Instruments**
Financial instruments are required to be classified as one of the following: held-to-maturity; loans and receivables, fair value through profit or loss; available-for-sale or other financial liabilities.

The Company's financial instruments include cash, accounts and other receivable, accounts payable and accrued liabilities. The Company designated its cash as fair value through profit or loss, its accounts and other receivable as loans and receivables, and its accounts payable and accrued liabilities as other financial liabilities.

Fair value through profit or loss financial assets are measured at fair value with gains and losses recognized in operations. Financial assets, loans and receivables and other financial liabilities are measured at amortized cost. Available-for-sale financial assets are measured at fair value with unrealized gains and losses recognized in other comprehensive income .

Fair value of a financial instrument is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. The fair value of a financial instrument on initial recognition is the transaction price, which is the fair value of the consideration given or received. Subsequent to initial recognition, the fair value of a financial instrument that is quoted in active markets is based on the bid price for a financial asset held and the offer price for a financial liability. When an independent price is not available, fair value is determined by using a valuation methodology which refers to observable market data. Such a valuation technique includes comparisons with a similar financial instrument where an observable market price exists, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. If no reliable estimate can be made, the Company measures the financial instrument at cost less impairment as a last resort.

**Property and equipment**
Property and equipment are recorded at cost. Depreciation is calculated based on the estimated useful life of the asset using the following rates:

| | **New** |
|---|---|
| Machinery and equipment | Straight Line, 5 years |
| Office equipment | Straight Line, 5 years |

**Patents and licenses**
Patents and licenses are recorded at cost and amortized on a straight line basis over their estimated useful lives. Ongoing maintenance costs are expensed as incurred. The expiry of the patents and licenses range from 6 - 12 years (See note 19).

**Impairment of long-lived assets**
The Company's tangible and intangible assets are reviewed for indications of impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. An assessment is made at each reporting date whether there is any indication that an asset may be impaired.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

An impairment loss is recognized when the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit and loss for the year. The recoverable amount is the greater of the asset's 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 an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit ("CGU") to which the asset belongs.

An impairment loss is reversed if there is an indication that there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized. The Company has not recorded an impairment loss in 2014 or 2013.

**Income taxes**
The Company follows the liability method of accounting for income taxes. Under this method, deferred income taxes are provided on differences between the financial reporting and income tax bases of assets and liabilities and on income tax losses available to be carried forward to future years for tax purposes. Deferred income taxes are measured using the substantively enacted tax rates and laws which are expected to be in effect when the differences are expected to reverse. Valuation allowances are provided to reduce deferred income tax assets to the amount expected to be realized.

**Other Income - Government grants**
Government grants received exclusively from the Department of Defense of the United States of America and NASA, relating to research and development, are recognized as other income, net, based on the agreed upon milestones of the projects. Other income earned on government grants in 2014 was $169,832 (2013 - $261,984).

**Research and development costs**
Research costs are expensed in the year incurred. Development costs are also expensed in the year incurred unless the Company believes a development project meets IFRS criteria as set out in IAS 38, *Intangible Assets*, for deferral and amortization.

**Stock-based compensation**
Stock options and warrants awarded to non employees are accounted for using the fair value of the instrument awarded or service provided whichever is considered more reliable. Stock options and warrants awarded to employees are accounted for using the fair value method. The fair value of such stock options and warrants granted is recognized as an expense on a proportionate basis consistent with the vesting features of each tranche of the grant. The fair value is calculated using the Black-Scholes option pricing model with assumptions applicable at the date of grant.

**Loss per share**
Basic loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the year. Diluted loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the year after giving effect to potentially dilutive financial instruments. The dilutive effect of stock options and warrants is determined using the treasury stock method.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The following new accounting policy was adopted on January 1, 2014:

Financial instruments
IAS 32, *Financial Instruments; Offsetting Financial Assets and Financial Liabilities*
The amendment provides further clarification on the application of the offsetting requirements. The adoption of this pronouncement did not have an impact on the Company's consolidated financial statements.

## 3. RECENT ACCOUNTING PRONOUNCEMENTS

The following is a summary of recent accounting pronouncements that may affect the Company.

(i) Financial instruments
IFRS 9, *Financial Instruments,* replaces IAS 39, Financial Instruments: Recognition and Measurement. The new standard requires entities to classify financial assets as being measured either at amortized cost or fair value depending on the business model and contractual cash flow characteristics of the asset. For financial liabilities, IFRS 9 requires an entity choosing to measure a liability at fair value to present the portion of the change in its fair value due to change in the entity's own credit risk in the other comprehensive income rather than in the statement of profit or loss. The new standard applies to annual years beginning on or after January 1, 2015.

## 4. MARKETABLE SECURITIES

Marketable securities consist of small investments in three companies carrying a market value of nil as of September 30, 2014 and $397 as of December 31, 2013.

## 5. PROPERTY AND EQUIPMENT

| | Construction in progress | Machinery and equipment | Office equipment | Total |
|---|---|---|---|---|
| **Cost** | | | | |
| Balance, January 1, 2013 | $ - | $ 27,500 | $ 2,335 | $ 29,835 |
| Additions | - | 931,449 | 6,411 | 937,860 |
| Balance, December 31, 2013 | - | 958,949 | 8,746 | 967,695 |
| Additions | 271,160 | 32,159 | 45,242 | 348,561 |
| Balance, September 30, 2014 | 271,160 | 991,108 | 53,988 | 1,316,256 |
| **Accumulated Depreciation** | | | | |
| Balance, January 1, 2013 | - | 2,750 | 415 | 3,165 |
| Depreciation for the year | - | 59,250 | 1,488 | 60,738 |
| Balance, December 31, 2013 | - | 62,000 | 1,903 | 63,903 |
| Depreciation for the period | - | 146,954 | 5,756 | 152,710 |
| Balance, September 30, 2014 | - | 208,954 | 7,659 | 216,613 |
| **Carrying Amounts** | | | | |
| At December 31, 2013 | $ - | $ 896,949 | $ 6,843 | $ 903,792 |
| At September 30, 2014 | $ 271,160 | $ 782,154 | $ 46,329 | $ 1,099,643 |

## 6. PATENTS AND LICENSES

| | |
|---|---|
| **Cost** | |
| Balance, January 1, 2013 | $ 103,229 |
| Additions | 62,923 |
| Balance, December 31, 2013 | 166,152 |
| Additions | 70,798 |
| Balance, September 30, 2014 | 236,950 |
| **Accumulated Depreciation** | |
| Balance, January 1, 2013 | 27,679 |
| Amortization/impairment | 12,797 |
| Balance, December 31, 2013 | 40,476 |
| Amortization | 14,023 |
| Balance, September 30, 2014 | 54,499 |
| **Carrying Amounts** | |
| At December 31, 2013 | $ 125,676 |
| At September 30, 2014 | $ 182,451 |

See note 19 for explanation on a change in accounting policy relating to patents and licenses.

## 7. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

| | **September 30, 2014** | December 31, 2013 |
|---|---|---|
| Trade payable | **$ 76,722** | $ 94,824 |
| Payroll related liabilities | **218,215** | 89,243 |
| Accrued liabilities | **322,928** | 71,960 |
| | **$ 617,865** | $ 256,027 |

## 8. SHARE CAPITAL

(a) AUTHORIZED

Unlimited number of common shares

1 Special voting share

(b) COMMON SHARES ISSUED

| | Number of Shares | | Amount |
|---|---|---|---|
| Balance, January 1, 2013 | 117,528,615 | $ | 40,225,401 |
| Shares issued on the exercise of stock options | 607,500 | | 152,502 |
| Fair value of stock options exercised | - | | 121,368 |
| Shares issued on private placement | 14,400,000 | | 7,189,200 |
| Fair value of warrants and compensation warrants issued | - | | (4,308,292) |
| Share issue costs | - | | (529,222) |
| Shares issued on the exercise of warrants and compensation warrants | 140,000 | | 37,111 |
| Fair value of warrants exercised | - | | 23,387 |
| Balance, December 31, 2013 | 132,676,115 | | 42,911,455 |
| Shares issued on the exercise of stock options | 3,430,000 | | 886,093 |
| Fair value of stock options exercised | - | | 748,193 |
| Shares issued on private placements | 7,692,307 | | 4,546,000 |
| Fair value of warrants and compensation warrants issued | - | | (4,146,957) |
| Shares issued on the exercise of warrants and compensation warrants | 18,083,462 | | 7,704,441 |
| Fair value of warrants and compensation warrants exercised | - | | 3,542,730 |
| Warrant exercise incentive | - | | (31,711) |
| Shares issued for reduction of license fee | 2,000,000 | | 1,439,898 |
| Balance, September 30, 2014 | 163,881,884 | $ | 57,600,142 |

On February 13, 2014, the Company completed a $4,546,000 (CAD $5,000,000) private placement financing. The financing consisted of 7,692,307 units at a price of $0.59 (CAD $0.65) per unit. Each unit comprises one common share and one common share purchase warrant. One warrant allows the holder to acquire one common share of the Company at an exercise price of $0.91 (CAD $1.00) per share for a period of 2 years. No commission was payable with respect to this financing.

The fair value of the warrants was estimated using the Black-scholes option pricing model with the following assumptions: dividend yield of 0%, interest rate of 1.017%, volatility of 92.22% and estimated life of 2 years. The estimated fair value assigned to the warrants was $4,146,957.

During the period, the Company paid $31,711 (CAD $35,000) as incentives for the exercise of warrants.

## 9. WARRANTS

The following table reflects the continuity of warrants:

| | Average Exercise Price | Number of Warrants | Historical Fair value |
|---|---|---|---|
| Balance, January 1, 2013 | $ 0.33 | 26,778,569 | $ 3,850,685 |
| Warrants issued | 0.75 | 14,400,000 | 3,825,178 |
| Compensation warrants issued | 0.50 | 1,440,000 | 483,114 |
| Exercised | 0.17 | (140,000) | (23,387) |
| Balance, December 31, 2013 | 0.48 | 42,478,569 | 8,135,590 |
| Warrants issued | 0.91 | 7,692,307 | 4,146,957 |
| Expired | 0.29 | (3,500) | (756) |
| Exercised | 0.43 | (18,083,462) | (3,542,730) |
| Balance, September 30, 2014 | $ 0.61 | 32,083,914 | $ 8,739,061 |

As at September 30, 2014 the following warrants were outstanding:

| | Number of Warrants | Historical Fair Value ($) | Exercise Price ($) | Expiry Date |
|---|---|---|---|---|
| | 10,186,000 | 2,705,782 | 0.75 | February 14, 2015 |
| | 1,622,348 | 214,048 | 0.34 | June 8, 2015 |
| | 731,544 | 96,431 | 0.34 | June 22, 2015 |
| | 1,332,000 | 179,119 | 0.34 | July 31, 2015 |
| | 1,320,039 | 180,344 | 0.34 | September 7, 2015 |
| | 5,325,000 | 738,140 | 0.34 | September 13, 2015 |
| | 2,298,000 | 315,783 | 0.35 | September 27, 2015 |
| | 6,734,577 | 3,630,707 | 0.91 | February 12, 2016 |
| Compensation warrants | 1,411,855 | 473,672 | 0.50 | February 14, 2016 |
| Compensation warrants | 38,040 | 6,659 | 0.22 | June 22, 2016 |
| Compensation warrants | 11,250 | 2,006 | 0.22 | July 31, 2016 |
| Compensation warrants | 36,361 | 6,587 | 0.22 | September 7, 2016 |
| Compensation warrants | 536,900 | 98,681 | 0.22 | September 13, 2016 |
| Compensation warrants | 500,000 | 91,102 | 0.22 | September 27, 2016 |
| | 32,083,914 | 8,739,061 | 0.61 | |

These warrants were issued in Canadian dollars and are exercisable at prices ranging from $0.23 CAD and $1.00 CAD.

## 10. STOCK OPTIONS AND CONTRIBUTED SURPLUS

**Stock Options**

On August 12, 2014, shareholders of the Company approved amendments to the Company's fixed 20% stock option plan (as amended, referred to as the "2014 Plan"). Under the 2014 Plan, the board of directors may grant options to acquire common shares of the Company to qualified directors, officers, employees and consultants. The 2014 Plan provides that the number of common shares issuable pursuant to options granted under the 2014 Plan and pursuant to other previously granted options is limited to 31,925,000 (the “Number Reserved”). Any subsequent increase in the Number Reserved must be approved by shareholders of the Company and cannot, at the time of the increase, exceed 20% of the number of issued and outstanding shares. Options granted under the 2014 Plan generally vest 25% immediately and 25% every six months from the date of issue, however, the directors may, at their discretion, specify a different vesting period.

## 10. STOCK OPTIONS AND CONTRIBUTED SURPLUS (Continued)

Stock option transactions and the number of stock options outstanding were as follows:

| | Number of Options | Weighted average Exercise Price |
|---|---|---|
| Balance, January 1, 2013 | 17,602,750 | $ 0.35 |
| Expired/cancelled | (572,500) | 0.53 |
| Exercised | (607,500) | 0.25 |
| Granted | 7,310,000 | 0.46 |
| Balance, December 31, 2013 | 23,732,750 | 0.38 |
| Expired/cancelled | (150,000) | 0.47 |
| Exercised | (3,430,000) | 0.27 |
| Granted | 6,155,000 | 1.26 |
| Balance, September 30, 2014 | 26,307,750 | $ 0.60 |

During the period, the Company granted 6,155,000 (2013 - 5,630,000) stock options to officers, employees and consultants of the Company to purchase common shares at an average price of $1.26 (2013 - $0.45) per share.

During the period, the Company recorded stock-based compensation of $3,571,665 (2013 - $3,060,448) relating to stock options that vested during the period.

The stock options granted were valued using the Black-Scholes option pricing model using the following assumptions;

| | **2014** | 2013 |
|---|---|---|
| Weighted average risk-free interest rate | **1.58%** | 1.54% |
| Weighted average dividend yield | **0%** | 0% |
| Weighted average volatility | **102%** | 115% |
| Weighted average estimated life | **5 years** | 5 years |

Share price on the various grant dates were:

| | | |
|---|---|---|
| First grant | $ 1.31 | $ 0.53 |
| Second grant | 1.10 | 0.50 |
| Third grant | 1.64 | 0.44 |
| Fourth grant | 1.13 | 0.46 |
| Fifth grant | - | 0.47 |

The underlying expected volatility was determined by reference to the Company's historical share price movements, its dividend policy and dividend yield and past experience relating to the expected life of granted stock options.

## 10. STOCK OPTIONS AND CONTRIBUTED SURPLUS (Continued)

The weighted average remaining contractual life and weighted average exercise price of options outstanding and of options exercisable as at September 30, 2014 are as follows:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Range | Number Outstanding | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) | Number Exercisable | Weighted Average Exercise Price |
| $0.11 - $0.25 | 4,055,000 | $ 0.22 | 3.90 | 4,055,000 | $ 0.22 |
| $0.28 - $0.31 | 721,250 | $ 0.27 | 3.68 | 721,250 | $ 0.27 |
| $0.34 - $0.37 | 892,500 | $ 0.33 | 5.88 | 892,500 | $ 0.33 |
| $0.38 - $0.86 | 14,284,000 | $ 0.45 | 3.75 | 12,136,500 | $ 0.45 |
| $0.87 - $1.64 | 6,355,000 | $ 1.26 | 4.88 | 1,750,000 | $ 1.26 |
| | 26,307,750 | $ 0.60 | 4.11 | 19,555,250 | $ 0.45 |

### Contributed Surplus

The following table reflects the continuity of contributed surplus:

| | Amount |
|---|---|
| Balance, January 1, 2013 | $ 16,361,282 |
| Stock-based compensation | 4,021,153 |
| Fair value of stock options exercised | (121,368) |
| Fair value of expired warrants | - |
| Balance, December 31, 2013 | 20,261,067 |
| Stock-based compensation | 3,571,665 |
| Fair value of stock options exercised | (748,193) |
| Fair value of expired warrants | 756 |
| Balance, September 30, 2014 | $ 23,085,295 |

## 11. LOSS PER SHARE

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| Numerator | | | | |
| Net loss | **$ (4,397,485)** | $ (2,280,104) | **$ (9,156,471)** | $ (5,883,751) |
| Denominator | | | | |
| Weighted average number of common shares outstanding | **163,014,051** | 132,583,098 | **153,566,080** | 130,060,889 |
| Weighted average number of common shares outstanding - diluted | **163,014,051** | 132,583,098 | **153,556,080** | 130,060,889 |
| Basic and diluted loss per share | **$ (0.03)** | $ (0.02) | **$ (0.06)** | $ (0.05) |

The effect on the net loss in 2014 and 2013 of the shares to be issued on exercise of common share purchase options, warrants, compensation warrants is not reflected as they are anti-dilutive.

## 12. COMMITMENTS AND CONTINGENCIES

The Company has two operating leases for office space and research facilities expiring September 30, 2015 and March 14, 2018.

Rent expense under these leases was $36,333 and $108,996 for the three and nine months ended September 30, 2014 (2013 - $36,333 and $97,411).

Remaining minimum annual rental payments to the lease expiration dates are as follows:

| | |
|---|---|
| 2014 | $ 36,333 |
| 2015 and after | 175,515 |
| | $ 211,848 |

## 13. RELATED PARTY TRANSACTIONS

Compensation to key management personnel were as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| Salaries | **$ 348,580** | $ 192,200 | **$ 907,240** | $ 564,431 |
| Share-based payments (1) | **1,260,883** | 342,999 | **1,660,750** | 990,142 |
| Total | **$ 1,609,463** | $ 535,199 | **$ 2,567,990** | $ 1,554,573 |

(1) Share-based payments are the fair value of options granted to key management personnel and expensed during the year.

During the nine months ended September 30, 2014, the Company settled $100,000 that was advanced to the former CEO of the Company. The amount was non interest bearing and short-term in nature. The Company settled the amount due from the former CEO in return for a reduction in his compensation and certain other entitlements.

During the nine months ended September 30, 2014, the former CEO of the Company received a severance package of $185,000 to be paid over one year. The full amount of the severance package has been accounted for during the period.

The Company paid $67,069 and $121,030 in fees and disbursements (2013 - $25,664 and $42,311) to a law firm, of which a director is counsel, for legal services rendered to the Company for the three and nine months ended September 30, 2014.

All transactions with related parties have occurred in the normal course of operations and are measured at the exchange amounts, which are the amounts of consideration established and agreed to by the related parties.

## 14. SEGMENT INFORMATION

The Company and its subsidiary operates in a single segment; the design of semi-conductor products for military and industrial applications. The Company's operating and reporting segment reflects the management reporting structure of the organization and the manner in which the chief operating decision maker regularly assesses information for decision making purposes, including the allocation of resources. A summary of the Company's operating segment is below:

## 14. SEGMENT INFORMATION (Continued)

**ODIS Inc. ("ODIS")**
ODIS develops the technology to produce a monolithic, integrated opto electronic microchip having several potential major market applications: infrared sensor arrays for Homeland Security monitoring and imaging along with the unique combination of optical lasers, and electronic control circuits on the same microchip for potential applications in various military programs and potentially telecom for Fibre to The Home. ODIS' technology also provides the opportunity for higher speed computing capabilities.

The Company operates geographically in the United States and Canada. Geographical information is as follows:

**2014**

| **As of September 30,** | **US** | **Canada** | **Consolidated** |
|---|---|---|---|
| **Current assets** | **$ 4,243,884** | **$ 8,115,633** | **$ 12,359,517** |
| **Property and equipment** | **1,099,643** | **-** | **1,099,643** |
| **Patents and licenses** | **182,451** | **-** | **182,451** |
| | **$ 5,525,978** | **$ 8,115,633** | **$ 13,641,611** |

| | **US** | **Canada** | **Consolidated** |
|---|---|---|---|
| **Nine months ended September 30,** | | | |
| **General and administration** | **$ 1,337,750** | **$ 6,265,996** | **$ 7,603,746** |
| **Research and development** | **1,722,557** | **-** | **1,722,557** |
| **Other income** | **(169,832)** | **-** | **(169,832)** |
| | **$ 2,890,475** | **$ 6,265,996** | **$ 9,156,471** |

2013

| As of September 30, | US | Canada | Consolidated |
|---|---|---|---|
| Current assets | $ 1,427,344 | $ 3,290,483 | $ 4,717,827 |
| Property and equipment | 409,739 | - | 409,739 |
| Patents and licenses | 128,875 | - | 128,875 |
| Construction in progress | 481,010 | - | 481,010 |
| | $ 2,446,968 | $ 3,290,483 | $ 5,737,451 |

| | US | Canada | Consolidated |
|---|---|---|---|
| Nine months ended September 30, | | | |
| General and administration | $ 1,197,206 | $ 3,656,772 | $ 4,853,978 |
| Research and development | 1,291,757 | - | 1,291,757 |
| Other income | (261,984) | - | (261,984) |
| | $ 2,226,979 | $ 3,656,772 | $ 5,883,751 |

## 15. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Company's financial instruments consist of cash, short-term investments, accounts and other receivable, marketable securities, accounts payable and accrued liabilities and customer deposits. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. The Company estimates that the fair value of these instruments approximate the carrying values due to their short term nature.

The Company has classified financial assets as follows:

| | **September 30, 2014** | December 31, 2013 |
|---|---|---|
| Fair value through profit or loss, measured at fair value: | | |
| Cash | **$ 12,281,016** | $ 3,260,967 |
| Available-for-sale, measured at fair value: | | |
| Marketable securities | **-** | 397 |
| | **$ 12,281,016** | $ 3,261,364 |

Financial instruments recorded at fair value on the balance sheet are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

Level 1 - valuation based on quoted prices (unadjusted) observed in active markets for identical assets or liabilities.
Level 2 - valuation techniques based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or indirectly.
Level 3 - valuation techniques based on inputs for the asset or liability that are not based on observable market data.

Cash was determined using level 1 inputs.

**Exchange Rate Risk**
The functional currency of each of the entities included in the accompanying consolidated financial statements is the local currency where the entity is domiciled. Functional currencies include the US and Canadian dollar. Most transactions are conducted in functional currencies. As such, none of the entities included in the consolidated financial statements engage in hedging activities. The Company is exposed to a foreign currency risk with the Canadian dollar. A 10% change in the Canadian dollar would increase or decrease other comprehensive income by $792,863.

**Liquidity Risk**
The Company currently does not maintain credit facilities. The Company's existing cash and cash resources are considered sufficient to fund operating and investing activities over the next twelve months.

## 16. CAPITAL MANAGEMENT

In the management of capital, the Company includes shareholders equity (excluding accumulated other comprehensive income, deficit and non controlling interest) and cash. The components of capital on September 30, 2014 were:

| | |
|---|---|
| Cash | $ 12,281,016 |
| Shareholders equity | $ 89,424,498 |

The Company's objective in managing capital is to ensure that financial flexibility is present to increase shareholder value through growth and responding to changes in economic and/or market conditions; to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business and to safeguard the Company's ability to obtain financing should the need arise.

In maintaining its capital, the Company has a strict investment policy which includes investing its surplus capital only in highly liquid, highly rated financial instruments.

The Company reviews its capital management approach on an ongoing basis. There were no changes in the Company's approach to capital management during the year.

## 17. EXPENSES

Research and development costs can be analysed as follows:

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| Wages and benefits | **$ 201,970** | $ 184,619 | **$ 668,656** | $ 517,323 |
| Subcontract fees | **256,059** | 145,075 | **414,239** | 328,039 |
| Stock-based compensation | **123,363** | 179,683 | **543,276** | 369,806 |
| Supplies | **46,102** | 22,792 | **96,386** | 76,589 |
| | **$ 627,494** | $ 532,169 | **$ 1,722,557** | $ 1,291,757 |

General and administrative costs can be analysed as follows:

| | | | | |
|---|---|---|---|---|
| Stock-based compensation | **$ 2,489,972** | $ 1,152,871 | **$ 3,028,391** | $ 2,690,642 |
| Wages and benefits | **405,012** | 118,865 | **1,122,529** | 602,554 |
| Professional fees | **325,695** | 241,761 | **773,455** | 447,382 |
| Management and consulting fees | **290,327** | 155,984 | **455,627** | 426,003 |
| General expenses | **157,878** | 88,963 | **502,890** | 534,160 |
| Rent | **35,057** | 41,092 | **114,223** | 107,482 |
| Depreciation and amortization | **66,050** | 33,027 | **166,733** | 45,755 |
| Shares issued for reduction of license fee | **-** | - | **1,439,898** | - |
| | **$ 3,769,991** | $ 1,832,563 | **$ 7,603,746** | $ 4,853,978 |

## 18. REDUCTION OF LICENSE FEE

The University of Connecticut agreed to convert certain royalty rights into a significant investment in the Company. The parties agreed to restructure the payment provisions of the License Agreement by reducing royalty payments to three percent (3%) of amounts received from unaffiliated third parties in respect of the exploitation of the Intellectual Property defined in the License Agreement, in consideration for 2,000,000 common shares of the Company. The common shares were valued at $1,439,898 (CAD $1,580,000). The market value of shares were determined using the quoted market price of the stock on the date of the agreement between the Company and the University of Connecticut.

## 19. ACCOUNTING POLICY CHANGE

During the period, the Company made an accounting policy change to capitalize its patent registration costs. The previous accounting policy was to charge all patent registration costs against profit and loss in the year those costs are incurred (see note 2).

The new accounting policy was adopted in the current period and has been applied retrospectively. Management believes that the change in accounting policy will provide more relevant and reliable information. The Company is developing an intangible process which is increasing the net worth of the Company. Each patent filed, increases the value of the Company. This retrospective change in accounting policy provides more transparent information relating to these assets as they are expected to provide future economic benefits and they can be measured reliably.

The impact of the change in accounting policy on the Consolidated Statement of Operations and Deficit, Consolidated Statement of Comprehensive Loss, Consolidated Statement of Financial Position and Consolidated Statements of Cash Flows is set out below:

Consolidated Statements of Operations and Deficit:

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|---|---|
| Net loss previously reported | $ (2,281,833) | $ (5,940,221) |
| Differences (increasing) decreasing reported net loss | | |
| General and administrative expenses | 1,729 | 56,470 |
| Net loss | (2,280,104) | (5,883,751) |
| Deficit beginning of period | (62,752,692) | (59,149,045) |
| Deficit end of period | $ (65,032,796) | $ (65,032,796) |
| Loss per share previously reported | $ (0.01) | $ (0.03) |
| Loss per share as restated | $ (0.01) | $ (0.03) |
| Deficit, previously reported | | $ (65,118,473) |
| Effects due to change in accounting policy: | | |
| Years prior to 2013 | | 29,207 |
| 2013 | | 56,470 |
| Deficit | | $ (65,032,796) |

## 19. ACCOUNTING POLICY CHANGE (Continued)

Consolidated Statements of Comprehensive Loss:

| | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2013 |
|---|---|---|
| Comprehensive loss previously reported | $ (2,215,376) | $ (6,109,916) |
| Adjustment to net loss due to change in accounting policy | 1,729 | 56,470 |
| Comprehensive loss | $ (2,213,647) | $ (6,053,446) |

Consolidated Statements of Financial Position:

| | Balance as previously reported December 31, 2013 | Change in accounting policy | Balance as adjusted |
|---|---|---|---|
| Patents and licenses previously reported, December 31, 2013 | $ 38,790 | $ 86,886 | $ 125,676 |
| Deficit | $ (67,081,588) | $ 86,886 | $ (66,994,702) |

Consolidated Statements of Cash Flows:

Patents and licenses that are capitalized are included as part of cash flows from investing activities whereas patent registration costs that are expensed, and amortization of capitalized costs are included as part of cash flows from operating activities. This has resulted in additional cash outflows from investing activities being relating to capitalized patent registration costs of $62,923 for the period ended September 30, 2013. This has also resulted in a corresponding reduction being reflected in the net cash outflow from operating activities of $62,923. Non-cash operating activities relating to the amortization of patent registration costs increased by $6,453 for the period ended September 30, 2013.

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