

Consolidated Financial Statements of

**PHOTON CONTROL INC.**

Years ended December 31, 2006 and 2005



**KPMG LLP**  
**Chartered Accountants**  
PO Box 10426 777 Dunsmuir Street  
Vancouver BC V7Y 1K3  
Canada

Telephone (604) 691-3000  
Fax (604) 691-3031  
Internet [www.kpmg.ca](http://www.kpmg.ca)

## **AUDITORS' REPORT TO THE SHAREHOLDERS**

We have audited the consolidated balance sheets of Photon Control Inc. as at December 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

**KPMG LLP (signed)**

Chartered Accountants

Vancouver, Canada

March 2, 2007

# PHOTON CONTROL INC.

Consolidated Balance Sheets

December 31, 2006 and 2005

	2006	2005
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 2,435,006	\$ 3,737,207
Trade accounts receivable and other	950,903	602,278
Inventory	676,245	183,196
Prepaid expenses and deposits	359,441	148,706
	<u>4,421,595</u>	<u>4,671,387</u>
Property and equipment (note 3)	756,273	450,155
Intangible assets (note 4)	158,751	97,438
	<u>\$ 5,336,619</u>	<u>\$ 5,218,980</u>

## Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,406,220	\$ 975,270
Deferred revenue	75,000	82,500
	<u>1,481,220</u>	<u>1,057,770</u>
Other liabilities	310,499	310,499
Deferred rent (note 8)	86,752	-
Shareholders' equity (note 5):		
Share capital	27,069,284	24,202,787
Contributed surplus	1,450,785	1,010,363
Deficit	(25,061,921)	(21,362,439)
	<u>3,458,148</u>	<u>3,850,711</u>
Continuing operations (note 1)		
Commitments and contingencies (notes 4 and 8)		
Subsequent events (note 12)		
	<u>\$ 5,336,619</u>	<u>\$ 5,218,980</u>

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:

"S. Robert Blair" Director

"Hugh Wynne-Edwards" Director

# PHOTON CONTROL INC.

## Consolidated Statements of Operations and Deficit

Years ended December 31, 2006 and 2005

	2006	2005
Revenue	\$ 6,090,163	\$ 2,897,647
Cost of sales	3,382,767	1,731,391
	2,707,396	1,166,256
Operating expenses (note 9):		
General and administrative	1,373,770	1,389,697
Research and development	4,090,138	3,841,179
Business development and marketing	832,659	696,842
Amortization	180,969	197,496
	6,477,536	6,125,214
	(3,770,140)	(4,958,958)
Other earnings (expenses):		
Interest and other earnings	86,482	16,848
Interest expense	(11,562)	(12,214)
Foreign exchange	(4,262)	(45,066)
	70,658	(40,432)
Loss for the year	(3,699,482)	(4,999,390)
Deficit, beginning of year	(21,362,439)	(16,363,049)
Deficit, end of year	\$ (25,061,921)	\$ (21,362,439)
Basic and diluted loss per share (note 5(f))	\$ (0.05)	\$ (0.09)

See accompanying notes to consolidated financial statements.

# PHOTON CONTROL INC.

## Consolidated Statements of Cash Flows

Years ended December 31, 2006 and 2005

	2006	2005
Cash provided by (used in):		
Operations:		
Loss for the year	\$ (3,699,482)	\$ (4,999,390)
Non-cash items:		
Amortization	180,969	197,496
Amortization of stock-based compensation	334,802	390,229
Loss (gain) on disposal of assets	2,815	(3,871)
Deferred rent expense	86,752	-
Changes in non-cash operating working capital:		
Trade accounts receivable and other	(348,625)	(379,674)
Inventory	(493,049)	(77,051)
Prepaid expenses and deposits	(210,736)	(48,533)
Accounts payable and accrued liabilities	430,950	494,926
Deferred revenue	(7,500)	(9,531)
	(3,723,104)	(4,435,399)
Financing:		
Proceeds from issue of common shares	3,333,015	8,462,261
Share issue costs	(360,898)	(609,235)
	2,972,117	7,853,026
Investments:		
Purchase of equipment	(462,257)	(326,713)
Proceeds from disposals of equipment	2,393	8,374
Purchase of intangible assets	(91,350)	(44,729)
	(551,214)	(363,068)
Increase (decrease) in cash and cash equivalents	(1,302,201)	3,054,559
Cash and cash equivalents, beginning of year	3,737,207	682,648
Cash and cash equivalents, end of year	\$ 2,435,006	\$ 3,737,207
Supplementary information:		
Cash received for interest	\$ 86,482	\$ 16,848
Cash paid for Interest	11,562	12,214
Non-cash financing and investing activities:		
Fair value of agent's warrants granted on share issuance (note 5(d))	113,370	210,060
Reclassification of contributed surplus to common shares upon exercise of stock options	7,750	50,300

See accompanying notes to consolidated financial statements.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

---

## 1. Nature of and continuing operations:

Photon Control Inc. (the Company) is incorporated under the laws of British Columbia. The Company's operations are focused on developing and commercializing new optical switching and sensing technologies and new optical meters and analyzers for various industries. On August 17, 2000, the Company completed an initial public offering of its common shares, which are listed on the TSX Venture Stock Exchange under the trading symbol PHO. In 2002, the Company changed its name from Coldswitch Technologies Inc. to Photon Control Inc.

During the years ended December 31, 2006 and 2005, the Company incurred losses of \$3,699,482 and \$4,999,390, respectively. As at December 31, 2006, the Company had an accumulated deficit of \$25,061,921 (2005 - \$21,362,439).

These financial statements have been prepared by management on a going-concern basis, which assumes that the Company will continue in operation for the foreseeable future and will be able to realize its assets and settle its liabilities and commitments in the normal course of business.

The Company's future operations are dependent upon the market's acceptance of its products in order to ultimately generate future profitable operations, and the Company's ability to secure sufficient financing to fund future operations. There can be no assurance that the Company's new products will be able to secure market acceptance. These financial statements do not include any adjustments that might result from the outcome of these uncertainties.

On October 11, 2006 the Company announced that it had entered into an engagement agreement with agents in connection with a proposed private placement to raise gross proceeds of \$2,500,000 plus an over-allotment option for an additional \$500,000. As disclosed in note 5(b), the first and second tranche of this private placement were closed in November and December 2006 involving gross proceeds of \$2,563,695. In addition, the over-allotment option was closed in February 2007 providing additional gross proceeds of \$436,305 (note 12(a)). The net proceeds of the private placement will be used to finance sales efforts to the semiconductor industry and to assist in the commercialization of oil and gas and power industry product technologies. The proceeds of this private placement, along with restructuring activities undertaken by the Company in 2006 to implement Research and Development expense reductions, and the closing of the Calgary sales office and the expectation of continued sales increases, are key factors in management's opinion that the Company will meet its liabilities and commitments as they become due.

## 2. Significant accounting policies:

### (a) Basis of presentation:

These financial statements consolidate the accounts of the Company and its subsidiary companies. Certain of these subsidiary companies are inactive and all material intercompany balances and transactions have been eliminated.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

---

## 2. Significant accounting policies (continued):

### (b) Use of estimates:

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported revenue and expenses during the years. Significant items subject to such estimates and assumptions include the carrying amount of equipment and intangible assets, and valuation allowances for receivables and inventory and assumptions used in determining the fair value of options and warrants.

These financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

### (c) Inventory:

Inventory consists of optical, mechanical and electronic components and finished goods and is valued at the lower of cost, determined on a weighted-average cost basis and replacement cost for optical, mechanical and electronic components and net realizable value for finished goods.

### (d) Property and equipment:

Property and equipment are stated at cost. Amortization is provided on the declining balance basis at the following annual rates:

Asset	Rate
Lab equipment	20%
Computers, office furniture and equipment	20%
Computer software	100%
Production equipment	30%
Leasehold improvements	Over the term of the lease

### (e) Intangible assets:

The costs of acquiring intangible assets, consisting of licenses and patents, are capitalized. Costs are amortized over the lesser of the estimated useful life of the intangible asset or the license term. The Company's management evaluates recoverability based on estimated future net cash flows compared to carrying value. If intangible assets are not considered to be fully recoverable, a provision is recorded for the unrecoverable amount.

### (f) Revenue recognition:

Revenue from sales of products is recognized when goods are shipped and title passes, there is persuasive evidence of an arrangement, collection is probable and the fee is fixed and determinable.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

---

## 2. Significant accounting policies (continued):

### (g) Research and development costs:

Research costs are expensed as incurred. Development costs are expensed as incurred unless they meet certain specified criteria for deferral and amortization. The Company has not incurred development costs which meet the criteria for deferral.

### (h) Government assistance:

The Company makes periodic applications for financial assistance under available government incentive programs. Government assistance relating to capital expenditures is reflected as a reduction of the cost of such assets, while government assistance relating to current expenses is recorded as a reduction of such expenses. The benefits of government assistance are recognized when there is reasonable assurance that they will be realized. Reasonable assurance is considered to have occurred when the relevant authorities have indicated that the Company's research and development activities qualify for government assistance.

The Company has received nil (2005 - \$138,085) in government assistance during the year ended December 31, 2006 which has been recorded as a reduction to expenses (note 9).

### (i) Loss per share:

Basic loss per share amounts are calculated by dividing the net loss by the weighted average number of common shares outstanding during the year. Diluted loss per share amounts are computed similarly to basic earnings per share except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of additional options and warrants, if dilutive. The number of additional shares is calculated by assuming that outstanding stock options and warrants were exercised and that the proceeds from such exercises were used to acquire shares of common stock at the average market price during the year.

### (j) Income taxes:

The Company uses the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases, and losses carried forward. The resulting future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in income in the period in which the change in tax rate is enacted or substantively enacted. Future income tax assets are evaluated and, if realization is not considered "more likely than not", a valuation allowance is provided.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 2. Significant accounting policies (continued):

(k) Share issue costs:

The costs of issuing common shares are applied to reduce the stated value of such shares.

(l) Translation of foreign currencies:

Monetary items denominated in foreign currencies are translated to Canadian dollars at exchange rates in effect at the balance sheet dates and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenue and expenses are translated at rates in effect at the time of the transactions. Foreign exchange gains and losses are included in earnings.

(m) Stock-based compensation plans:

The Company has a stock-based compensation plan, which is described in note 5(d). The Company accounts for employee stock options using the fair value based method. Under the fair value based method, compensation cost attributable to options granted to employees and directors is measured at the fair value at the grant date using the Black-Scholes option pricing model. Compensation expense is recognized over the vesting period of the underlying option. Any consideration paid by employees on exercise of stock options or purchase of stock is credited to share capital. No compensation cost is recognized for options that employees forfeit if they fail to satisfy the service requirement for vesting. Compensation expense is recognized for stock-based payments to non-employees using the fair value based method.

(n) Comparative figures:

Certain of the comparative figures (primarily cost of sales, general and administrative and research and development) have been reclassified to conform with the presentation adopted for the current year.

## 3. Property and equipment:

	2006			2005		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Lab equipment	\$ 261,711	\$ 95,802	\$ 165,909	\$ 213,144	\$ 58,152	\$ 154,992
Computers, office furniture and equipment	245,818	94,489	151,329	198,684	62,093	136,591
Computer software	85,867	78,247	7,620	60,413	44,553	15,860
Production equipment	237,204	70,348	166,856	119,757	36,161	83,596
Leasehold improvements	295,248	30,689	264,559	77,721	18,605	59,116
	<u>\$ 1,125,848</u>	<u>\$ 369,575</u>	<u>\$ 756,273</u>	<u>\$ 669,719</u>	<u>\$ 219,564</u>	<u>\$ 450,155</u>

# PHOTON CONTROL INC.

## Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

---

#### 4. Intangible assets:

	2006	2005
Cost	\$ 591,072	\$ 499,723
Accumulated amortization	(432,321)	(402,285)
	<u>\$ 158,751</u>	<u>\$ 97,438</u>

In 2002, the Company entered into a license for flow meter technology for \$400,000 payable in instalments. The license was to expire September 2005 or earlier if a flow meter was commercialized. The Company is currently in negotiation to complete its purchase of the technology pursuant to an option in the original agreement, on revised terms from the original agreement reflecting changes in the Company's planned use of the technology. The original cost has been fully amortized as at December 31, 2006 and 2005.

The purchase price, and future royalties will be accounted for prospectively when finally agreed with the Vendor.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 5. Share capital:

### (a) Authorized:

Shareholder approval for amending the Company's authorized share capital to an unlimited number of Common and Preferred Shares without par value was obtained at the Company's annual meeting on June 22, 2005. Previously, the authorized share capital was limited to 100,000,000 common shares and 100,000,000 preferred shares.

### (b) Issued and outstanding:

Common shares:

	Number of shares	Stated values
Issued and outstanding as at December 31, 2004	45,444,347	16,509,521
Issued for cash pursuant to private placement (i)	2,402,430	840,851
Issued for cash pursuant to private placement (ii)	11,250,000	4,500,000
Exercise of warrants	9,115,361	2,816,384
Exercise of stock options	1,261,250	305,026
Reclassification of contributed surplus on exercise of stock options	-	50,300
Share issue costs	-	(819,295)
Issued and outstanding as at December 31, 2005	69,473,388	24,202,787
Issued for cash pursuant to private placement (iii)	1,250,000	500,000
Issued for cash pursuant to private placement (iv)	14,874,200	2,231,130
Issued for cash pursuant to private placement (v)	2,217,100	332,565
Exercise of warrants	603,630	259,321
Exercise of stock options	25,000	10,000
Reclassification of contributed surplus on exercise of stock options	-	7,750
Share issue costs	-	(474,269)
Issued and outstanding as at December 31, 2006	88,443,318	\$ 27,069,284

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 5. Share capital (continued):

(b) Issued and outstanding (continued):

Contributed surplus	Amount
Balance, December 31, 2004	\$ 460,374
Issue of warrants for financing proceeds and services	210,061
Stock-based compensation to employees	296,653
Stock-based compensation to non-employees	93,575
Reclassification of contributed surplus to common shares upon exercise of stock options	(50,300)
Balance, December 31, 2005	1,010,363
Issue of warrants for financing proceeds and services	113,370
Stock-based compensation to employees	342,403
Stock-based compensation to non-employees	(7,601)
Reclassification of contributed surplus to common shares upon exercise of stock options	(7,750)
Balance, December 31, 2006	\$ 1,450,785

Private placements:

- (i) On January 7, 2005, the Company completed a private placement of 2,402,430 units at a price of \$0.35 per unit. Each unit consists of one common share of the Company and one-half of a non-transferable warrant. Each whole warrant was exercisable to purchase one common share of the Company at \$0.45 until January 7, 2006. A total of 2,402,430 common shares were issued for gross proceeds of \$840,851 and \$63,580 was paid in issue costs. In addition 240,243 warrants, which were exercisable until January 7, 2006 at \$0.35, were issued to the broker as compensation.
- (ii) On December 16, 2005, the Company completed a private placement of 11,250,000 units at a price of \$0.40 per unit. Each unit consists of one common share of the Company and one-half of a non-transferable warrant. Each whole warrant is exercisable to purchase one common share of the Company at \$0.55 until June 16, 2007. A total of 11,250,000 common shares were issued for gross proceeds of \$4,500,000 and \$424,562 was paid in issue costs. In addition 900,000 warrants, which are exercisable until June 16, 2007 at \$0.55, were issued to the broker as compensation.
- (iii) On January 17, 2006, the Company completed an over-allotment of the private placement of 1,250,000 units at a price of \$0.40 per unit. Each unit consists of one common share of the Company and one-half of a non-transferable warrant. Each whole warrant is exercisable to purchase one common share of the Company at \$0.55 until July 18, 2007. A total of 1,250,000 common shares were issued for gross proceeds of \$500,000 and \$48,000 was paid in issue costs.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

---

## 5. Share capital (continued):

### (b) Issued and outstanding (continued):

Private placements (continued):

(iv) On November 17, 2006, the Company completed the first tranche of a private placement of 14,874,200 units at a price of \$0.15 per unit. Each unit consists of one common share of the Company and one-half of a non-transferable warrant. Each whole warrant is exercisable to purchase one common share of the Company at \$0.21 until May 17, 2008. A total of 14,874,200 common shares were issued for gross proceeds of \$2,231,130 and \$219,753 was paid in issue costs. In addition 1,123,269 non-transferable warrants, which are exercisable until November 17, 2008 at \$0.15, were issued to the broker as compensation.

(v) On December 13, 2006, the Company completed the second tranche of a private placement of 2,217,100 units at a price of \$0.15 per unit. Each unit consists of one common share of the Company and one-half of a non-transferable warrant. Each whole warrant is exercisable to purchase one common share of the Company at \$0.21 until June 13, 2008. A total of 2,217,100 common shares were issued for gross proceeds of \$332,565 and \$22,634 was paid in issue costs. In addition 123,800 non-transferable warrants, which are exercisable until December 13, 2008 at \$0.15, were issued to the broker as compensation.

### (c) Treasury shares:

Pursuant to Purchase and Sale Agreements dated April 5, 2000 between the Company and certain individuals, the Company acquired all of the issued and outstanding shares of CST Coldswitch Holdings Inc. in exchange for the issuance of 1,400,000 of the Company's common shares. The sole asset of CST Coldswitch Holdings Inc. is 1,400,000 of the Company's common shares which have been assigned a value of \$700,000. These shares have been recorded as treasury shares, and accordingly, the cost of the shares has been deducted from share capital.

### (d) Stock options:

On June 22, 2005 at the Company's annual general meeting, shareholder approval was obtained to revise the stock option plan by establishing the number of options reserved for the plan as 10% of the issued and outstanding shares in the Company. Accordingly, as at December 31, 2006, the Company's board of directors had reserved 8,844,332 (December 31, 2005 - 6,947,339) options for issuance under the Company's stock option plan. The plan provides that options may be granted with an exercise price of no less than the greater of 75% of the market price of the Company's stock on the date of the grant and \$0.10. The Company has granted options with an exercise price equal to the market price at the date of grant. The plan also provides that the term of the options shall not exceed five years and that the minimum option vesting period shall be 18 months with a maximum vesting of 25% per six month period.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 5. Share capital (continued):

(d) Stock options (continued):

Stock option transactions are summarized as follows:

	Number of shares	Weighted average exercise price
Outstanding, December 31, 2004	4,685,000	\$ 0.31
Granted	1,850,000	0.56
Exercised	(1,261,250)	0.24
Cancelled	(65,000)	0.40
Expired	(262,500)	1.00
Outstanding, December 31, 2005	4,946,250	0.38
Granted	2,085,000	0.26
Exercised	(25,000)	0.40
Cancelled	(1,017,500)	0.42
Expired	(532,500)	0.25
Outstanding, December 31, 2006	5,456,250	\$ 0.34

The following table summarizes the stock options outstanding at December 31, 2006:

Exercise price	Options outstanding			Options exercisable	
	Number of shares	Weighted average remaining contractual life (years)	Weighted average exercise price	Number of options exercisable	Weighted average exercise price
\$0.13 to \$0.20	1,442,500	2.66	\$ 0.18	727,500	\$ 0.18
\$0.24 to \$0.50	2,895,000	2.88	0.33	1,760,000	0.33
\$0.52 to \$1.00	1,118,750	3.74	0.58	640,000	0.61
	5,456,250	3.00	\$ 0.34	3,127,500	\$ 0.35

The options outstanding at December 31, 2006 expire between February 26, 2007 and December 6, 2011. The per share weighted average fair value of stock options granted during 2006 was \$0.31 (2005 - \$0.43).

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 5. Share capital (continued):

### (d) Stock options (continued):

The fair value of options granted was estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2006	2005
Expected option lives	5 years	5 years
Risk-free interest rate	4.09%	3.59%
Dividend yield	0%	0%
Volatility	108%	103%

The Company has applied the fair value based method of accounting for stock options granted after January 1, 2003. During the year ended December 31, 2006, the Company recorded \$334,802 of compensation expense representing the fair value of the options vesting during the year with a corresponding increase to contributed surplus. In addition, included in share issue costs and credited to contributed surplus for the year is \$113,370 related to the fair value of 1,247,069 agent's warrants issued.

### (e) Warrants:

Information related to the Company's share purchase warrant activity for the year ended December 31, 2005 and 2006 is as follows:

Expiry dates	Exercise price	Balance, December 31, 2005	Issued	Exercised	Expired	Balance, December 31, 2006
January 7, 2006	\$0.45	1,201,215	-	458,000	743,215	-
January 7, 2006	\$0.35 <sup>(ii)</sup>	123,170	61,565	123,130	61,605	-
January 7, 2006	\$0.45 <sup>(iii)</sup>	22,500		22,500		-
June 16, 2007	\$0.55	5,625,000				5,625,000
June 16, 2007	\$0.40 <sup>(ii)</sup>	900,000				900,000
July 18, 2007	\$0.55		625,000			625,000
May 17, 2008	\$0.21		7,437,099			7,437,099
November 17, 2008	\$0.15 <sup>(ii)</sup>		1,123,269			1,123,269
June 13, 2008	\$0.21		1,108,549			1,108,549
December 13, 2008	\$0.15 <sup>(ii)</sup>		123,800			123,800
		7,871,885	10,479,282	603,630	804,820	16,942,717

# PHOTON CONTROL INC.

## Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

### 5. Share capital (continued):

#### (e) Warrants (continued):

Expiry dates	Exercise price	Balance, December 31, 2004	Issued	Exercised	Expired	Balance, December 31, 2005
February 24, 2005	\$0.30	800,000	-	700,000	100,000	-
June 19, 2005	\$0.15	953,643	-	953,643	-	-
July 10, 2005	\$0.15	1,899,480	-	1,899,480	-	-
July 23, 2005	\$0.15	83,000	-	83,000	-	-
June 3, 2005	\$0.36/\$0.40 <sup>(i)</sup>	1,297,333	-	1,297,333	-	-
June 3, 2005	\$0.30 <sup>(ii)</sup>	188,326	-	188,326	-	-
June 3, 2005	\$0.36/\$0.40 <sup>(iii)</sup>	28,750	94,163	122,913	-	-
June 29, 2005	\$0.36/\$0.40 <sup>(i)</sup>	353,500	-	353,500	-	-
June 29, 2005	\$0.30 <sup>(ii)</sup>	70,700	-	70,700	-	-
June 29, 2005	\$0.36/\$0.40 <sup>(iii)</sup>	-	35,350	35,350	-	-
August 3, 2005	\$0.36/\$0.40 <sup>(i)</sup>	1,671,950	-	1,615,950	56,000	-
August 3, 2005	\$0.30 <sup>(ii)</sup>	317,690	-	275,290	42,400	-
August 3, 2005	\$0.36/\$0.40 <sup>(iii)</sup>	8,350	137,644	145,994	-	-
November 30, 2005	\$0.45	602,142	-	117,000	485,142	-
December 10, 2005	\$0.45	1,339,497	-	632,429	707,068	-
December 10, 2005	\$0.35 <sup>(ii)</sup>	388,328	-	387,391	937	-
December 10, 2005	\$0.45 <sup>(iii)</sup>	-	193,694	83,953	109,741	-
January 7, 2006	\$0.45	-	1,201,215	-	-	1,201,215
January 7, 2006	\$0.35 <sup>(ii)</sup>	-	240,243	117,073	-	123,170
January 7, 2006	\$0.45 <sup>(iii)</sup>	-	58,536	36,036	-	22,500
June 16, 2007	\$0.55	-	5,625,000	-	-	5,625,000
June 16, 2007	\$0.40 <sup>(ii)</sup>	-	900,000	-	-	900,000
		10,002,689	8,485,845	9,115,361	1,501,288	7,871,885

<sup>(i)</sup> Each whole warrant is exercisable to purchase one common share of the Company at \$0.36 for the first nine months and thereafter \$0.40 for the remaining nine month term.

<sup>(ii)</sup> These are agents' options to purchase units, which are issued as commissions with respect to private placements referred to in note 5(b). Each unit consists of one common share and one half of one common share purchase warrant.

<sup>(iii)</sup> These are warrants created as a result of the agents' exercising of their option to purchase units.

#### (f) Loss per share:

The weighted average number of shares outstanding during the year ended December 31, 2006 of 73,175,709 (year ended December 31, 2005 - 53,868,094) was used in the calculation of basic loss per share. Exercise of all of the stock options and share purchase warrants referred to in note 5(d) and 5(e) is anti-dilutive for all years presented.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 6. Income taxes:

### (a) Effective tax rate:

The effective income tax rates differ from the Canadian statutory rates for the following reasons:

	2006	2005
Combined federal and provincial taxes at the expected rate of 34.12% (2005 - 34.87%)	\$ (1,262,263)	\$ (1,743,287)
Non-capital losses expiring and expenses not otherwise deductible for tax	126,586	54,788
Future income tax expense resulting from reduction in statutory tax rate	-	200,101
Change in valuation allowance	1,005,395	1,300,800
Permanent differences	117,383	139,979
Other	12,899	47,619
Provision for recovery of income taxes	\$ -	\$ -

### (b) Future tax assets:

Future tax assets arise from difference between tax and accounting values related to the following:

	2006	2005
Property and equipment	\$ 311,879	\$ 324,097
Intangible assets	179,431	105,890
Non-capital loss carryforwards	5,451,154	4,820,663
Reserves	46,320	-
Scientific research and development expenses	921,706	555,149
Share issue costs	144,653	243,948
Total gross future tax assets	7,055,143	6,049,747
Valuation allowance	(7,055,143)	(6,049,747)
Net future tax assets	\$ -	\$ -

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

---

## 6. Income taxes (continued):

### (b) Future tax assets (continued):

As at December 31, 2006, the Company has non-capital loss carryforwards for income tax purposes of approximately \$15,976,421 available to reduce taxable income of future years. These losses expire as follows:

---

2007	\$ 870,634
2008	1,869,566
2009	1,472,372
2010	1,563,365
2011	2,217,479
2014	4,619,777
2015	3,363,228
	<hr/>
	\$ 15,976,421

---

The Company has research and development expenditures of \$2,701,365 which are available to reduce taxable income of future years. These amounts can be carried forward indefinitely.

The Company has unamortized share issue costs for tax purposes of \$784,850 which are available to reduce taxable income of future years as follows:

---

2006	\$ 281,510
2007	237,134
2008	194,026
2009	72,180
	<hr/>
	\$ 784,850

---

The Company has federal and provincial Scientific Research and Experimental Development (SR&ED) investment tax credits in the amount of \$692,473 as a result of incurring research and development costs in prior years. The Company can utilize these investment tax credits to offset future corporate income taxes. They expire ten years from the year in which the investment tax credits are earned.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

---

## 7. Related party transactions:

During the year ended December 31, 2006, directors of the Company were granted a total of 575,000 (2005 - 545,000) stock options with a weighted average exercise price of \$0.30 (2005 - \$0.64) per share as consideration for services provided to the Company.

Directors and officers participated in private placements acquiring 1,900,000 common shares and 950,000 warrants to purchase common shares for proceeds of \$285,000 in 2006 and 198,500 common shares and 99,250 warrants to purchase common shares in 2005 for proceeds of \$77,975.

On November 15, 2005, the Company's President provided the Company with a short term loan of \$125,000 providing interest at an annual rate of 5%. The loan was fully repaid by the Company on December 21, 2005.

## 8. Commitments and contingencies:

### (a) Leases:

The Company has entered into premises and office equipment leases requiring the following minimum lease payments as follows:

---

2007	\$	626,053
2008		755,172
2009		761,523
2010		760,535
2011		589,456
		<hr/>
		\$ 3,492,739

---

The above lease commitment amounts are prior to rental expense recoveries of \$87,078 per annum for 2007 to 2010 in relation to sub-lease agreements executed in 2006.

The Company entered into a new lease agreement in June 2006 and has recorded \$86,752 in deferred rent to account for the rent-free benefit received in 2006.

### (b) Litigation:

In October 2001, a former member of management and director of the Company (the Claimant) initiated arbitration asserting that certain amounts were owing to him by the Company. The Company denies that it owes these amounts.

In addition, the Claimant has filed a claim against the Company seeking unquantified damages for wrongful dismissal. The Company considers the allegations in the lawsuit to be without merit and intends to defend the action. The Company has also filed a counterclaim.

It is not possible to determine the likely outcome of these litigation matters, nor is it possible to determine the nature and amount of consideration, if any, which the Company may have to pay or which it may collect as a result of these proceedings. Provision has been made in the accounts of the Company for these actions.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 9. Supplementary statement of operations information:

	2006	2005
General and administrative:		
Salaries and fees	\$ 521,101	\$ 607,983
Office premises expenses	203,348	116,158
Legal and accounting	253,323	270,291
Insurance	143,745	123,497
Investor relations	22,386	11,260
Directors fees	153,009	203,440
Other	76,858	57,068
	<u>\$ 1,373,770</u>	<u>\$ 1,389,697</u>
Research and development:		
Salaries and fees	\$ 2,467,078	\$ 2,223,653
Materials	899,377	817,453
Certification and testing	41,742	139,651
Consulting fees	341,397	406,375
Government grants received	-	(138,085)
Other	340,544	392,132
	<u>\$ 4,090,138</u>	<u>\$ 3,841,179</u>
Business development and marketing:		
Salaries and fees	\$ 590,764	\$ 305,655
Travel expenses	87,809	128,229
Consulting fees	47,093	178,538
Promotion	26,815	39,707
Other	80,178	44,713
	<u>\$ 832,659</u>	<u>\$ 696,842</u>

## 10. Financial instruments:

Carrying amounts of certain of the Company's financial instruments, including cash and cash equivalents, trade accounts receivable and other, and accounts payable and accrued liabilities approximate fair values due to their short maturities.

# PHOTON CONTROL INC.

Notes to Consolidated Financial Statements

Years ended December 31, 2006 and 2005

## 11. Segmented information:

The Company is developing and commercializing optical switching and sensing technologies and primarily operates in one industry segment: however, the Company's recent and future commercialization of new products involves potential future diversification into two or three additional industry segments.

### (a) Geographic information:

Information regarding revenue earned from major customers by geographic segments, based on the location of the customer, is as follows:

	2006	2005
Revenue:		
Canada	\$ 126,779	\$ 83,552
United States	3,166,866	1,622,547
Europe	50,734	65,787
Taiwan	2,406,125	1,125,761
China	321,405	-
Other	18,254	-
	<u>\$ 6,090,163</u>	<u>\$ 2,897,647</u>

All of the Company's equipment and intangible assets are located in Canada.

### (b) Major customers:

The following table identifies revenue generated from individual customers comprising 10% or more of the Company's revenue:

	2006	2005
Entity A	\$ 2,427,455	\$ 1,176,941
Entity B	1,371,994	810,048
Entity C	984,429	-
Entity D	73,859	397,116
	<u>\$ 4,857,737</u>	<u>\$ 2,384,105</u>

## 12. Subsequent events:

Further to the private placement referred to in note 5(b)(iv) and 5(b)(v), the Engagement Agreement for the private placement provided an over-allotment option to the agents for an additional \$500,000 proceeds. On February 15, 2007 this over-allotment was closed and a total of 2,908,700 shares were issued for gross proceeds of \$436,305 and \$38,404 was paid in issue costs. In addition 232,695 warrants, which are exercisable until February 15, 2009 at \$0.15, were issued to the broker as compensation.