



PSP: TSX Venture Exchange  
www.pacsafety.com

# Investor Report

## Quarter One Fiscal 2005

For the Three Months Ended September 30, 2004 and September 30, 2003

## Message to Shareholders

### Review

In the first quarter of fiscal 2005 we have focused on the next step of optimizing the opportunities provided by the award of two major Canadian military contracts. With the award of these major contracts comes the pride of knowing that years of hard work have paid off and the excitement of a future with all the challenges and rewards it entails. We expect to see significant revenue generated from these contracts beginning in the third quarter of fiscal 2005. With focused management of the production of these products, PSP will have a solid revenue stream for the next several years.

This does not mean that management and staff can rest on these watershed achievements. Winning these contracts is only the first step in an exciting journey for all members of our team. The Sales and Marketing team is tasked to increase growth in our core business and to develop and close new opportunities provided by PSP's current success. The Operations team must meet the challenge of executing the ramp up of operating capacity for these large orders while maintaining the excellent delivery times to our current customers. The Finance and Administration team has two major objectives. First, to ensure that reporting controls are in place to assist us to exceed the expected profitability of our current business and of our new business. Second, make sure that necessary financial resources are in place to expand our business in the future. The Finance and Administration team has already ensured the financial resources are in place to meet the working capital requirements of our current business in hand with a \$2.8 million equity financing completed in September.

Although seemingly overshadowed in magnitude by the Canadian military contracts, another important event occurred during the quarter. PSP won a contract with a United States security firm worth approximately \$300,000. This is the most significant contract we have won in the US in the last number of years and is an important in-road for the Company. We believe it is only the beginning of increased business in this market.

Quarter one also saw the culmination of our search for an Executive Vice-President of Sales and Marketing. Daniel Ripchensky has over 20 years of experience developing high-performing sales and marketing teams that have consistently over-achieved. Mr. Ripchensky's responsibilities will include expanding existing markets and identifying new domestic and international markets for PSP products. He will also be responsible for developing new marketing initiatives focused on increasing overall corporate sales.

### The Future

Our current success in winning contracts proves out the strategy we have followed over the last number of years. Our success with the Canadian military bolsters our reputation worldwide as a leading supplier of innovative safety products. The worldwide concern about safety and security and protecting against terrorist threats will likely not change for many years. As the Chief Executive Officer, I am looking forward to developing and executing strategies that will take advantage of this new environment. Now more than ever we must approach new markets with integrated system solutions, rather than stand alone products. With an order book between \$46 and \$57 million, excellent access to financial capital, and a strong management team, I believe we can meet future challenges and exceed current expectations.

I thank again all of our major stakeholders including our customers, investors, employees and suppliers and I hope they are as excited about PSP's future as I am.

Sincerely,

A handwritten signature in black ink, appearing to be 'B. Field', written in a cursive style.

Brad Field, President and Chief Executive Officer  
Pacific Safety Products Inc.

## **MANAGEMENT DISCUSSION AND ANALYSIS**

The purpose of this document is to provide a first quarter update to the information contained in Management's Discussion and Analysis section of Pacific Safety Products Inc.'s ("PSP" or "the Company") 2004 annual report. This discussion is intended to aid readers in understanding the Company's history, business environment, strategies, performance and risk factors through "the eyes of management". The information provided should be read in conjunction with PSP's 2004 annual report and the accompanying unaudited interim financial statements and notes for the first quarter ended September 30, 2004. The information in this report includes information available to October 29, 2004, and includes forward-looking statements based on current expectations and is subject to risks and uncertainties. Many internal and external factors may cause actual results to differ materially.

The following discussion and analysis is related to the Company's unaudited interim financial statements for the three months ended September 30, 2004 and September 30, 2003. It should be read in conjunction with the Company's unaudited interim financial statements and notes, for the three months ended September 30, 2004, and the Company's unaudited consolidated interim financial statements for the three months ended September 30, 2003, the Message to Shareholders and other management discussion included in this quarterly report. Reference should also be made to management's discussion and analysis included in the Company's last annual report, which includes audited consolidated financial statements for the years ended June 30, 2004 and June 30, 2003.

### **OVERVIEW OF THE BUSINESS**

The mission statement of Pacific Safety Products Inc. is *...we bring everyday heroes home safely™*. PSP is an established industry leader in the production, distribution and sale of high-performance and high-quality safety products. These products primarily include body armor to protect against ballistic, stab and fragmentation threats. PSP is the largest armor manufacturer in Canada and has significant international customers. The Company also produces tactical clothing and emergency medical kits. These products are marketed under the labels **Pacific Emergency Products®**, **PROTECTED by PSP™**, **EXPLOSAFE®**, and **O<sub>2</sub>B.O.S.S.™** The Company's primary customers include military agencies, law enforcement agencies, private security companies, fire departments and emergency medical service organizations.

The Company strives to provide quality protection solutions by effectively integrating the latest technologies to serve these customers' needs. Founded in 1984, PSP has grown to include more than 130 employees at three Canadian facilities in Kelowna, British Columbia; Brampton, Ontario; and Arnprior, Ontario. These facilities are equipped with complete design, production and research capabilities. The Kelowna facility has one of the most advanced non-government operated ballistic research labs in North America.

The financial data has been prepared in accordance with Canadian generally accepted accounting principles and the Company's reporting currency is the Canadian dollar. Pacific Safety Products Inc. is a reporting issuer in Canada in the provinces of British Columbia, Alberta and Ontario. The Company trades on the TSX Venture Exchange under the symbol PSP. Additional regulatory information relating to Pacific Safety Products Inc. can be found at the System for Electronic Document Analysis and Retrieval ("SEDAR") web site at [www.sedar.com](http://www.sedar.com).

### **Overall Strategy**

Pacific Safety Products Inc.'s strategic plan ("the Plan") is the Company's road map for growth. The Plan's primary objective is to achieve consistent quarter after quarter increases in revenue and profitability.

### **Envisioned Future**

To become the most innovative and practical solution provider in the safety products industry and have the PSP brand name synonymous with the finest quality safety products in the world.

### **Strategic Plan Objectives**

To increase significantly the amount of our base business through the plan's four main strategic imperatives:

- Maximize profit and capitalize on major contracts awards
- Create new product development initiatives in each market segment
- Use free cash-flow to acquire complementary businesses and technologies
- Selectively enter new markets

### **Capability to Deliver Results**

PSP management is confident it can deliver results because we have developed a team of highly skilled and dedicated individuals, we have streamlined our manufacturing facilities and we have the drive and ambition necessary to lead our Company to success. The Company has concrete orders, amounting to a minimum of \$46 million and potentially up to \$57 million, in hand, to deliver consistent revenue and profitability growth. By focusing on hiring and training new production staff, the Company will have the capacity to manufacture and deliver these orders to its customers. It has also secured the necessary financial resources to ramp up capacity and purchase raw materials for this business as well as develop future markets and products. A \$2.8 million equity financing was completed in September 2004, which will also provide for the potential of an additional \$1.7 million cash injection if all 1,999,998 warrants are exercised.

## OVERALL CORPORATE PERFORMANCE

### SUMMARY OF OPERATIONS

| THREE MONTHS ENDED                                    | SEPTEMBER 30, 2004 | SEPTEMBER 30, 2003 |
|---|--------------------|--------------------|
| SALES   | \$ 2,388,244       | \$ 4,030,594       |
| COST OF SALES   | 1,693,886          | 2,748,328          |
| GROSS MARGIN  | 694,358            | 1,282,266          |
| EXPENSES  | 1,132,776          | 803,864            |
| INTEREST ON LONG-TERM DEBT                            | 150,131            | 129,084            |
| TOTAL EXPENSES  | 1,282,907          | 932,948            |
| LOSS BEFORE INCOME TAXES                              | (588,549)          | 349,318            |
| INCOME TAXES RECOVERY                                 | (205,992)          | 122,267            |
| LOSS  | \$ (382,557)       | \$ 227,051         |
| BASIC LOSS PER SHARE                                  | \$ (0.030)         | \$ 0.018           |
| WEIGHTED AVERAGE COMMON SHARES ISSUED AND OUTSTANDING | 12,936,438         | 12,331,480         |

### CASHFLOW

| THREE MONTHS ENDED                            | SEPTEMBER 30, 2004 | SEPTEMBER 30, 2003 |
|---|--------------------|--------------------|
| Cash flow from continuing operations          | \$ (379,007)       | \$ (869,185)       |
| Investing activities and capital expenditures | (82,206)           | (367,448)          |
| Financing activities                          | 2,519,039          | (89,403)           |
|   | 2,057,826          | (1,326,036)        |

### FINANCIAL POSITION

| AS AT   | SEPTEMBER 30, 2004 | JUNE 30, 2004  | SEPTEMBER 30, 2003 |
|---|--------------------|----------------|--------------------|
| Cash and Cash Equivalents (Bank Indebtedness) | \$ 936,760         | \$ (1,121,066) | \$ (1,068,417)     |
| Working Capital                               | 3,548,539          | 1,348,455      | 1,814,500          |
| Term Debt (long-term portion only)            | 4,037,998          | 4,062,000      | 3,804,168          |
| Shareholders' Equity                          | 5,541,717          | 3,359,652      | 4,116,732          |

### CONSOLIDATED QUARTERLY RESULTS

Consolidated quarterly results are presented in the following table. Quarterly revenue and earnings will vary from quarter to quarter depending on the size of the order book and the timing of the award of significant contracts to PSP. It is difficult to predict when major contracts will be awarded. Once awarded, the production start dates of the large contracts and the timing of revenue recognized from these contracts can have a significant impact on results from quarter to quarter.

#### Eight Months Trailing Quarterly Results

|  | Q1 2005     | Q4 2004     | Q3 2004     | Q2 2004     | Q1 2004     | Q4 2003     | Q3 2003     | Q2 2003     |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Sales  | \$2,388,244 | \$3,429,766 | \$2,398,678 | \$2,701,610 | \$4,030,594 | \$2,205,527 | \$3,889,033 | \$4,012,007 |
| Net income (loss)                            | \$(382,557) | \$(342,442) | \$(295,378) | \$(239,140) | \$227,051   | \$(411,489) | \$42,101    | \$(89,590)  |
| Basic income (loss) per share <sup>(1)</sup> | \$(0.030)   | \$(0.027)   | \$(0.024)   | \$(0.019)   | \$0.018     | \$(0.033)   | \$0.003     | \$(0.007)   |

(1) Fully diluted income (loss) per share has not been disclosed, as it does not differ significantly from basic income (loss) per share.

### SELECTED ANNUAL INFORMATION

|                                       | 2004         | 2003         | 2002         |
|---------------------------------------|--------------|--------------|--------------|
| Total Revenue                         | \$12,560,648 | \$14,512,579 | \$19,331,937 |
| Net Income (loss)                     | \$(613,868)  | \$(306,046)  | \$309,097    |
| Total Assets                          | \$10,358,465 | \$9,804,484  | \$12,293,744 |
| Total Long-term Financial Liabilities | \$4,309,842  | \$4,125,007  | \$1,903,325  |
| Earnings (loss) per Share             | \$(0.050)    | \$(0.025)    | \$0.025      |

### MANAGEMENT'S EXPLANATION OF THE RESULTS OF OPERATIONS

The Company reported a loss after taxes of \$382,557 for the quarter ended September 30, 2004 compared to net income after taxes of \$227,051 in the same quarter last year. This decline was mostly attributable to decreased revenue as the Company was not able to replace revenue from a \$1.6 million in contract revenue realized in the first quarter of last year. In addition, the quarter had increased expenditures related to the scale up for production of large upcoming contracts.

## **SALES**

PSP recorded \$2.4 million in sales for the quarter ended September 30, 2004, which represents a decrease of \$1.6 million, or 40.7% over last year's quarter one. The Company experiences sales cycles that can be dependent on the award of contracts by major Canadian police forces and government departments. These cycles are, at times, not predictable and will cause variations in revenue and profitability from quarter to quarter. Included in last year's quarter one sales were one-time contracts totalling approximately \$1.6 million.

## **GROSS MARGIN**

Gross margin was 29% of revenue compared to 32% of revenue in the same period last year. The gross margin percentage decreased due to lower sales volumes, which resulted in fixed manufacturing overhead costs contributing to a larger portion of the cost of sales.

## **EXPENSES**

### **Sales and Marketing**

As expected, these expenditures increased as the Company invested more in its sales and marketing department. In September 2004, we completed our international search for an Executive Vice President ("EVP"), Sales and Marketing. The EVP is leading the sales and marketing team in developing increased exposure of our products by attending more tradeshows and increasing print advertising. As such, the sales and marketing expenses increased \$109,194 in the first quarter of fiscal 2005 compared to the same quarter last year due to increase salaries and wages and an increase in travel, tradeshows and advertising.

### **Research and Development**

Research and development expenditures totalled \$160,470 for the quarter compared to \$107,707 in quarter one last year. The increase of \$52,763 reflects PSP's commitment to provide complete solutions to our customers. Over the past year, PSP has expanded the research and development team, which has resulted in increased salaries and wages. The Company has also supported the team by sending members to international tradeshows to stay current with recent developments. The ever-increasing threat of terrorism clearly demands product solutions that mitigate the risk of bodily harm to front-line personnel. We will continue to dedicate resources to the research and development department to ensure that we are meeting the total needs of our clients.

### **General and Administration**

General and administration expenditures increased \$134,418 to \$487,669 compared to \$353,251 in the same quarter last year. Management hired an outside consultant to ensure the Company was taking advantage of available government tax credits. The balance of the increase is attributable mainly to one time expenditures for various corporate activities related to employee relations and public company compliance costs.

Amortization of property, plant and equipment increased \$7,935 to \$31,834 compared to \$23,899 in the same quarter last year. Amortization of other assets increased \$19,971 to \$38,561 compared to \$18,590 in quarter one of last year. This is due to increasing the amortization of product development costs related to new product lines. Goodwill was evaluated by management and it was determined that there was no impairment in value during the period, thus no adjustments were made.

Interest calculated on the operating line for the quarter increased \$4,631 to \$14,501 compared to \$9,870 in quarter one, fiscal 2004. The increase in this expenditure is due to a higher average operating line balance throughout the quarter. At quarter end, the balance of the operating line was repaid using the proceeds from the equity financing.

Interest on long-term debt increased \$21,047 to \$150,131 compared to \$129,084 in quarter one, fiscal 2004. This is a result of an additional \$500,000 drawn on the RoyNat Capital financing in December 2003 and increasing the bonus interest accrual to \$27,000. The bonus interest is being calculated and accrued based on the policy set out in note 6 of the unaudited interim financial statements.

### **Income Taxes**

Income taxes were calculated at an effective rate of 35% for the quarter ended September 30, 2004.

## **RESULTS OF OPERATIONS**

### **Loss Before Interest on Long-Term Debt and Income Taxes**

The Company incurred an operating loss of \$438,418, or \$0.034 per share, compared to an operating income of \$478,402, or \$0.039 per share in quarter one, fiscal 2004.

### **EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTIZATION ("EBITDA")**

For the quarter ended September 30, 2004 EBITDA was \$(323,745) compared to \$561,279 for the quarter ended September 30, 2003.

### **Loss After Taxes**

Increased operating expenditures, lower sales and higher costs for interest on long-term debt contributed to a larger loss than in the comparable quarter. This loss was \$382,557, or \$0.030 per share, compared to net income \$227,051, or \$0.018 per share in quarter one, fiscal 2004.

## Cash Flow

Cash flow used in operating activities was \$379,007 compared to \$869,185 in cash used in quarter one, fiscal 2004 using the direct method under generally accepted accounting principles. The change relates mainly to higher amounts of cash received from customers and lower amounts paid out to employees and suppliers during the quarter. \$82,206 was used for investments in new product development, intangible assets and property, plant and equipment compared to \$367,448 during the same period last year. These costs relate mainly to procuring manufacturing equipment. Financing activities increased cash by \$2,519,039 compared to \$89,403 used for debt repayment in quarter one, fiscal 2004. The proceeds from financing activities relate to the net proceeds of a \$2.8 million financing which closed September 22, 2004, and is being used to provide working capital. There were no other significant changes over the quarter and financing activities related mainly to the normal principal repayment of long-term debt.

## LIQUIDITY AND CAPITAL RESOURCES

### WORKING CAPITAL

PSP's liquidity was significantly enhanced in quarter one as the Company raised \$2.8 million through an equity offering. At September 30, 2004, PSP's working capital position was \$3,548,539 compared to \$1,814,500 at September 30, 2003. PSP has enough working capital to meet current commitments, deliver future orders and the Company now complies with all lenders' bank covenants.

### Bank Indebtedness

Bank indebtedness at the end of the quarter was fully repaid with the receipt of the equity proceeds. Currently PSP's maximum operating line is \$2 million dollars, and combined with the current cash on hand will be sufficient to deliver current orders in hand.

### Investment Tax Credits Receivable

\$136,337 in investment tax credits receivable were recorded at quarter end relating to scientific research and development expenses incurred in fiscal 2002, 2003 and 2004. At June 30, 2004 there was \$210,000 recorded, of which the Company has received \$73,663 in the first quarter.

### Future Income Taxes Recoverable

At September 30, 2004, PSP had accumulated an estimated \$1.9 million in tax loss carry forwards available to be used against future taxable income. PSP has recorded related future income taxes recoverable of \$674,361 at September 30, 2004 (June 30, 2004 - \$468,369, September 30, 2003 - \$240,200). This has been recorded as a current asset as forecasts based on the current order book and shipment schedule of the Fragmentation Protective Vest contract for the Canadian military will provide enough taxable income to use up loss carry forwards in the next fiscal year.

### Other Working Capital Items

Changes in other working capital items were due to normal operations.

## PROPERTY, PLANT AND EQUIPMENT AND OTHER ASSETS

During the quarter, the Company spent \$82,206 in investing activities related mainly to the purchase of manufacturing equipment. There were no other significant investments in this category.

## LONG-TERM DEBT

There were no significant changes in long-term debt during the quarter other than regular repayments of principal. \$150,000 of the unsecured subordinated debenture was repaid subsequent to September 30, 2004.

## SHARE CAPITAL

During the quarter, 92,000 stock options were exercised by employees for the issue of 92,000 common shares at a weighted average exercise price of \$0.44 per share for proceeds of \$40,150. During the quarter, 100,000 stock options were issued with a weighted average exercise price of \$1.20 per share. Currently there are 858,000 options outstanding with a weighted average exercise price of \$0.47. This represents nearly 5.2% of PSP's issued and outstanding common shares.

4,000,000 Units of the Company were issued during the quarter for gross proceeds of \$2.8 million. The proceeds were allocated as \$1,858,444 for 4,000,000 common shares issued and \$941,156 for 1,999,998 warrants issued. \$468,134 in issue costs related to this financing were recorded as a reduction of share capital. Due to a new accounting policy, \$202,696 was recorded as an increase in share capital related to compensation based on outstanding stock options. At September 30, 2004, PSP's issued and outstanding shares totalled 16,649,275 (June 30, 2004 - 12,557,275, September 30, 2003 - 12,331,480) of the 100,000,000 authorized to be issued.

## Comparison of Expected and Actual Use of Proceeds of Equity Financing

The Company completed a \$2.8 million equity financing during the quarter. The following schedule shows the expected and actual use of proceeds.

|                                     | Expected    | Actual      | Variance |
|-------------------------------------|-------------|-------------|----------|
| Working capital and financing costs | \$2,800,000 | \$2,800,000 | \$-      |

**OFF BALANCE SHEET FINANCING**

The Company does not have any significant off balance sheet financing arrangements and there were no significant changes in operating leases from those disclosed in the MD&A for the year ended June 30, 2004.

**RELATED PARTY TRANSACTIONS**

Disclosure of related party transactions is included in note 7 of the unaudited interim financial statements.

**CRITICAL ACCOUNTING ESTIMATES**

There were no significant changes in the critical accounting estimates as disclosed in the MD&A for the year ended June 30, 2004.

**FINANCIAL INSTRUMENTS**

Full disclosure of financial instruments is made in note 8 of the interim financial statements. There are no financial instruments other than those held in the ordinary course of business.

**RISKS AND UNCERTAINTIES**

There were no significant changes in risks and uncertainties as disclosed in the MD&A for the year ended June 30, 2004.

**OUTLOOK**

PSP has a significant amount of orders on hand, which are a minimum of \$46 million and could increase by another \$11 million if the Canadian government exercises options on current contracts. PSP is well positioned to deliver consistent quarterly results going forward as it has secured the necessary financial resources and has an excellent manufacturing plan to scale up production capacity. The Company should start realizing steady revenue and profitability growth in the upcoming quarters. The timing of the initial revenue from these contracts is dependent on when production commences.

**MEASURES NOT IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES**

The following measure included in this report does not have a standardized meaning under Canadian generally accepted accounting principles and, therefore, is unlikely to be comparable to similar measures presented by other companies:

EBITDA, while not a concept recognized by generally accepted accounting principles, is an indirect measure for operating cash flow, a significant indicator of the success of any business.

Forward-Looking Statements: This document may contain forward-looking statements based on management's expectations, estimates and projections. All statements that address expectations or projections about the future, including statements about the Company's strategy for growth, product development, market position, expected expenditures and financial results are forward-looking statements. Some of the forward-looking statements may be identified by words like "expects," "anticipates," "plans," "intends," "projects," "indicates" and similar expressions. These statements are not guarantees of future performance and involve a number of risks, uncertainties and assumptions. Many factors, including those discussed more fully elsewhere in this release and in documents, which may be filed with the British Columbia Securities Commission, the Alberta Securities Commission, the Ontario Securities Commission, the TSX Venture Exchange, as well as others, could cause results to differ materially from those stated. These factors include, but are not limited to changes in the laws, regulations, policies and economic conditions, including inflation, interest and foreign currency exchange rates, of countries in which the Company does business; competitive pressures; successful integration of structural changes, including restructuring plans, acquisitions, divestitures and alliances; cost of raw material, research and development of new products, including regulatory approval and market acceptance; and seasonality of sales in some products.

**PACIFIC SAFETY PRODUCTS INC.**  
**BALANCE SHEETS**  
**(UNAUDITED)**

| <b>AS AT</b>                                      | <b>SEPTEMBER 30,<br/>2004</b> | <b>JUNE 30,<br/>2004</b> | <b>SEPTEMBER 30,<br/>2003</b> |
|---|-------------------------------|--------------------------|-------------------------------|
| <b>ASSETS</b>                                     |                               |                          |                               |
| <b>CURRENT ASSETS</b>                             |                               |                          |                               |
| Cash and cash equivalents                         | \$ 936,760                    | \$ 50,326                | \$ 24,451                     |
| Accounts receivable                               | 1,851,553                     | 1,649,554                | 2,949,279                     |
| Corporation taxes recoverable                     | -                             | -                        | 185,116                       |
| Inventory (Note 3)                                | 1,668,500                     | 1,397,916                | 1,433,537                     |
| Prepaid expenses and deposits                     | 280,385                       | 270,261                  | 348,509                       |
| Investment tax credits receivable                 | 136,337                       | 201,000                  | -                             |
| Future income taxes recoverable                   | 674,361                       | 468,369                  | 240,200                       |
| <b>Total Current Assets</b>                       | <b>5,547,896</b>              | <b>4,037,426</b>         | <b>5,181,092</b>              |
| <b>PROPERTY, PLANT AND EQUIPMENT</b>              | <b>2,810,284</b>              | <b>2,813,461</b>         | <b>2,830,235</b>              |
| <b>OTHER ASSETS</b>                               | <b>323,706</b>                | <b>350,992</b>           | <b>483,269</b>                |
| <b>INTANGIBLE ASSETS</b>                          | <b>310,675</b>                | <b>322,233</b>           | <b>215,517</b>                |
| <b>GOODWILL</b>                                   | <b>2,834,353</b>              | <b>2,834,353</b>         | <b>2,834,353</b>              |
| <b>TOTAL ASSETS</b>                               | <b>\$ 11,826,914</b>          | <b>\$ 10,358,465</b>     | <b>\$ 11,544,466</b>          |
| <b>LIABILITIES</b>                                |                               |                          |                               |
| <b>CURRENT LIABILITIES</b>                        |                               |                          |                               |
| Bank indebtedness (Note 4)                        | \$ -                          | \$ 1,171,392             | \$ 1,092,868                  |
| Accounts payable and accrued liabilities          | 1,483,457                     | 1,128,190                | 1,902,744                     |
| Corporation taxes payable                         | -                             | -                        | 103,019                       |
| Deferred revenue                                  | 162,731                       | 23,356                   | 3,196                         |
| Current portion of long-term debt                 | 353,169                       | 366,033                  | 264,765                       |
| <b>Total Current Liabilities</b>                  | <b>1,999,357</b>              | <b>2,688,971</b>         | <b>3,366,592</b>              |
| <b>LONG-TERM DEBT</b>                             | <b>4,037,998</b>              | <b>4,062,000</b>         | <b>3,804,168</b>              |
| <b>FUTURE INCOME TAXES PAYABLE</b>                | <b>247,842</b>                | <b>247,842</b>           | <b>256,974</b>                |
| <b>TOTAL LIABILITIES</b>                          | <b>6,285,197</b>              | <b>6,998,813</b>         | <b>7,427,734</b>              |
| <b>SHAREHOLDERS' EQUITY</b>                       |                               |                          |                               |
| <b>EQUITY INSTRUMENTS</b> (Note 5)                | <b>7,098,520</b>              | <b>4,453,967</b>         | <b>4,370,128</b>              |
| <b>DEFICIT</b>                                    | <b>(1,556,803)</b>            | <b>(1,094,315)</b>       | <b>(253,396)</b>              |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>                 | <b>5,541,717</b>              | <b>3,359,652</b>         | <b>4,116,732</b>              |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> | <b>\$ 11,826,914</b>          | <b>\$ 10,358,465</b>     | <b>\$ 11,544,466</b>          |

The accompanying notes are an integral part of these financial statements.

**APPROVED BY THE BOARD OF DIRECTORS:**



John Jennings, Director



David Scott, Director

**PACIFIC SAFETY PRODUCTS INC.**  
**STATEMENTS OF OPERATIONS AND DEFICIT**  
**(UNAUDITED)**

| <b>FOR THE THREE MONTHS ENDED</b>   | <b>SEPTEMBER 30,<br/>2004</b> | <b>SEPTEMBER 30,<br/>2003</b> |
|---|-------------------------------|-------------------------------|
| <b>SALES</b>  | <b>\$ 2,388,244</b>           | <b>\$ 4,030,594</b>           |
| <b>COST OF SALES</b>  |                               |                               |
| Amortization of property, plant and equipment                               | 44,278                        | 40,388                        |
| Materials, labour and manufacturing overhead                                | 1,649,608                     | 2,707,940                     |
| Total Cost of Sales   | 1,693,886                     | 2,748,328                     |
| <b>GROSS MARGIN</b>   | <b>694,358</b>                | <b>1,282,266</b>              |
| <b>EXPENSES</b>   |                               |                               |
| Sales and marketing   | 399,741                       | 290,547                       |
| Research and development  | 160,470                       | 107,707                       |
| General and administration  | 487,669                       | 353,251                       |
| Interest on operating line  | 14,501                        | 9,870                         |
| Amortization of property, plant and equipment                               | 31,834                        | 23,899                        |
| Amortization of other assets  | 38,561                        | 18,590                        |
| Total Expenses  | 1,132,776                     | 803,864                       |
| <b>INCOME (LOSS) BEFORE INTEREST ON LONG-TERM DEBT AND<br/>INCOME TAXES</b> | <b>(438,418)</b>              | <b>478,402</b>                |
| <b>INTEREST ON LONG-TERM DEBT</b>   |                               |                               |
| Periodic interest on long-term debt   | 123,131                       | 114,084                       |
| Bonus interest on subordinated debenture (Note 6)                           | 27,000                        | 15,000                        |
| <b>TOTAL INTEREST ON LONG-TERM DEBT</b>                                     | <b>150,131</b>                | <b>129,084</b>                |
| <b>NET INCOME (LOSS) BEFORE INCOME TAXES</b>                                | <b>(588,549)</b>              | <b>349,318</b>                |
| <b>INCOME TAXES (RECOVERY)</b>  |                               |                               |
| Future  | (205,992)                     | 16,292                        |
| Current   | -                             | 105,975                       |
| Total Income Tax Recovery   | (205,992)                     | 122,267                       |
| <b>NET INCOME (LOSS)</b>  | <b>(382,557)</b>              | <b>227,051</b>                |
| <b>DEFICIT, BEGINNING</b>   | <b>(1,094,315)</b>            | <b>(480,447)</b>              |
| <b>CHANGE IN ACCOUNTING POLICY (Note 2)</b>                                 | <b>(79,931)</b>               | <b>-</b>                      |
| <b>DEFICIT, ENDING</b>  | <b>\$ (1,556,803)</b>         | <b>\$ (253,396)</b>           |
| <b>BASIC INCOME (LOSS) PER SHARE</b>  | <b>\$ (0.030)</b>             | <b>\$ 0.018</b>               |
| <b>WEIGHTED AVERAGE COMMON SHARES ISSUED AND OUTSTANDING</b>                | <b>12,936,438</b>             | <b>12,331,480</b>             |

The accompanying notes are an integral part of these financial statements.

**PACIFIC SAFETY PRODUCTS INC.**  
**STATEMENTS OF CASH FLOW**  
**(UNAUDITED)**

| <b>FOR THE THREE MONTHS ENDED</b>                               | <b>SEPTEMBER 30,<br/>2004</b> | <b>SEPTEMBER 30,<br/>2003</b> |
|---|-------------------------------|-------------------------------|
| <b>OPERATING ACTIVITIES</b>                                     |                               |                               |
| Cash receipts from customers                                    | \$ 2,395,665                  | \$ 2,173,925                  |
| Cash paid to suppliers and employees                            | (2,657,041)                   | (2,919,156)                   |
| Interest paid   | (117,631)                     | (123,954)                     |
| <b>CASH FLOW USED BY OPERATING ACTIVITIES</b>                   | <b>(379,007)</b>              | <b>(869,185)</b>              |
| <b>INVESTING ACTIVITIES</b>                                     |                               |                               |
| Purchase of property, plant and equipment                       | (72,768)                      | (306,538)                     |
| Proceeds from the sale of property, plant and equipment         | 1,500                         | -                             |
| Investment in new product development                           | (4,794)                       | (52,151)                      |
| Investment in intangible assets                                 | (6,144)                       | (8,759)                       |
| <b>CASH FLOW USED BY INVESTING ACTIVITIES</b>                   | <b>(82,206)</b>               | <b>(367,448)</b>              |
| <b>FINANCING ACTIVITIES</b>                                     |                               |                               |
| Repayment of long-term debt                                     | (36,866)                      | (85,926)                      |
| Proceeds from the issue of capital stock                        | 2,840,150                     | -                             |
| Costs related to financing                                      | (284,245)                     | (3,477)                       |
| <b>CASH FLOW FROM (USED BY) FINANCING ACTIVITIES</b>            | <b>2,519,039</b>              | <b>(89,403)</b>               |
| <b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>         | <b>2,057,826</b>              | <b>(1,326,036)</b>            |
| <b>CASH AND CASH EQUIVALENTS (BANK INDEBTEDNESS), BEGINNING</b> | <b>(1,121,066)</b>            | <b>257,619</b>                |
| <b>CASH AND CASH EQUIVALENTS (BANK INDEBTEDNESS), ENDING</b>    | <b>\$ 936,760</b>             | <b>\$ (1,068,417)</b>         |
| <b>REPRESENTED BY:</b>  |                               |                               |
| Cash and cash equivalents                                       | \$ 936,760                    | \$ 24,451                     |
| Bank indebtedness   | -                             | (1,092,868)                   |
|   | <b>\$ 936,760</b>             | <b>\$ (1,068,417)</b>         |
| <b>NON-CASH TRANSACTIONS</b>                                    |                               |                               |
| Stock based financing costs                                     | \$ (183,839)                  | \$ -                          |
| Stock based compensation expense                                | (88,686)                      | -                             |
| Increase in share capital                                       | 272,525                       | -                             |
|   | <b>\$ -</b>                   | <b>\$ -</b>                   |

The accompanying notes are an integral part of these financial statements.

## **1. SIGNIFICANT ACCOUNTING POLICIES**

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### **Basis of Presentation**

The accompanying unaudited financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and include the accounts of Pacific Safety Products Inc. The prior period comparative figures include the accounts of Pacific Safety Products Inc. and its wholly owned subsidiary, AEGIS Engineered Textile Products Inc. Effective February 29, 2004 AEGIS Engineered Textile Products Inc. was wound up into Pacific Safety Products Inc. The wind-up had no material effect on the Company's financial statements.

These unaudited interim financial statements follow the same accounting policies and methods of application as the most recent annual audited consolidated financial statements dated June 30, 2004. The disclosures provided herein are incremental to those included in the annual audited consolidated financial statements. These unaudited interim financial statements should be read in conjunction with the Company's June 30, 2004 annual audited consolidated financial statements.

### **Use of Estimates**

The presentation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make assumptions and estimates that affect the reported amounts and other disclosures in these financial statements. Actual results may differ from those estimates.

### **Net Income (Loss) Per Share**

Basic net income (loss) per share is calculated by dividing the net income (loss) for the period by the weighted average number of common shares outstanding during the period. The Company uses the treasury stock method for calculating the dilutive effect of the outstanding stock options and other dilutive securities. Under the treasury stock method, the weighted average number of common shares outstanding used for the calculation of diluted loss per share assumes that the proceeds to be received on the exercise of dilutive share options and warrants are used to repurchase common shares at the average market price during the period. The fully diluted net income (loss) per share has not been presented, as it does not differ materially from basic income (loss) per share.

### **Financial Instruments**

The Company carries a number of financial instruments. It is management's opinion that the Company is not exposed to a significant concentration of credit risk arising from these financial instruments. The Company is exposed to currency risk arising from these financial instruments as a substantial number of transactions are denominated in Canadian Dollars and United States dollars. The Company is exposed to interest rate risk as a portion of its long-term debt and its operating line are based on a floating interest rate. Unless otherwise noted, the fair value of these financial instruments approximates the carrying values.

### **Stock Based Compensation Plans**

Direct awards of stock and liabilities based on the price of common stock are measured at fair value at each reporting date, with the change in fair value reported in the statements of operations. Under the fair value based method, stock-based payments are measured at the fair value of the consideration received, or the fair value of the equity instruments issued, or liabilities incurred, whichever is more reliably measurable. The fair value of non-cash stock-based payments is periodically re-measured until counterparty performance is complete, and any change therein is recognized over the period and in the same manner as if the Company had paid cash instead of paying with or using equity instruments. The cost of non-cash stock-based payments that are fully vested and non-forfeitable at the grant date is measured and recognized at that date.

Under the fair value based method, compensation cost attributable to awards that are direct awards of shares, or share appreciation rights, which call for settlement by the issuance of equity instruments, is measured at fair value at the grant date, and recognized over the vesting period. Compensation costs attributable to awards, which call for settlement in cash or other assets, is measured at fair value at the grant date, and recognized over the vesting period. For awards that vest at the end of a vesting period, compensation cost is recognized on a straight-line basis; for awards that vest on a graded basis, compensation is recognized on a pro-rata basis over the vesting period. Consideration received on the exercise of stock options is recorded as share capital and the related contributed surplus is transferred to share capital.

## **2. CHANGE IN ACCOUNTING POLICY**

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Effective July 1, 2004, the Company adopted the new provisions of the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3870 "Stock-Based Compensation and other Stock-Based Payments" which now requires companies to adopt the fair value based method for all stock-based payments granted on or after January 1, 2002. As a result, the Company is required to expense stock options issued to employees, directors and non-employees. Previously, the Company was only required to disclose the pro forma effect of any stock options issued to employees and directors in the notes to the financial statements. This change has been applied retroactively resulting in an adjustment to retained earnings of \$79,931.

**PACIFIC SAFETY PRODUCTS INC.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2004 AND SEPTEMBER 30, 2003**

| <b>3. INVENTORY</b>        | <b>SEPTEMBER 30,<br/>2004</b> | <b>JUNE 30,<br/>2004</b> | <b>SEPTEMBER 30,<br/>2003</b> |
|----------------------------|-------------------------------|--------------------------|-------------------------------|
| Raw materials              | \$ 1,455,288                  | \$ 1,171,851             | \$ 1,090,420                  |
| Work in process            | 45,051                        | 27,682                   | 81,120                        |
| Finished goods and samples | 168,161                       | 198,383                  | 261,997                       |
|                            | <b>\$ 1,668,500</b>           | <b>\$ 1,397,916</b>      | <b>\$ 1,433,537</b>           |

**4. BANK INDEBTEDNESS AND COVENANTS**

The Company has an agreement with its bank to provide advances repayable on demand with interest payable monthly calculated at the bank prime lending plus 1.50% per annum. The loan is secured by a first priority general security agreement over accounts receivable, inventory and an assignment of insurance and is subject to a priority agreement between the Company and another financial institution. The maximum operating line is \$2,000,000 and is subject to margin requirements and covenants set by the banks. At September 30, 2004, the operating line balance was zero and the Company complied with all covenants.

**5. EQUITY INSTRUMENTS**

**Authorized**

The authorized share capital of the Company consists of 100,000,000 voting common shares without par value.

| <b>Issued</b>                      | <b>Number of Shares</b> | <b>Amount</b>       |
|------------------------------------|-------------------------|---------------------|
| Balance, June 30, 2003             | 12,331,480              | \$ 4,370,128        |
| Issuance of shares (a)             | 31,845                  | 11,146              |
| Issuance of shares (b)             | 13,950                  | 3,766               |
| Issuance of shares (c)             | 180,000                 | 70,350              |
| Less: Issuing costs                | -                       | (1,423)             |
| Balance, June 30, 2004             | 12,557,275              | 4,453,967           |
| <b>Issuance of shares (d)</b>      | <b>4,000,000</b>        | <b>1,858,844</b>    |
| <b>Issuance of warrants (d)</b>    | <b>-</b>                | <b>941,156</b>      |
| <b>Issuance of warrants (e)</b>    | <b>-</b>                | <b>69,841</b>       |
| <b>Issuance of shares (f)</b>      | <b>92,000</b>           | <b>40,150</b>       |
| <b>Less: Financing costs</b>       | <b>-</b>                | <b>(468,134)</b>    |
| <b>Stock-based compensation</b>    | <b>-</b>                | <b>202,696</b>      |
| <b>Balance, September 30, 2004</b> | <b>16,649,275</b>       | <b>\$ 7,098,520</b> |

The fair value of warrants was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility (0.13), risk-free interest rate (1.85%), and weighted average life of one year.

- (a) In 2003, the Company offered its third employee share ownership plan. Under the plan, employees were entitled to purchase up to 300,000 common shares at \$0.35 per share, which was the trading price at the time of offering. 44,391 shares were subscribed for of which 12,546 were issued in January 2003 and 31,845 were issued in December 2003.
- (b) In 2004, the Company offered its fourth employee share ownership plan. Under the plan, employees were entitled to purchase up to 300,000 common shares at \$0.27 per share, which was the trading price at the time of offering. 71,420 shares were subscribed for, of which 13,950 were issued in January 2004 and 57,470 are expected to be issued in December 2004.
- (c) In 2004, 180,000 common shares were issued at a weighted average price of \$0.48 per share through the exercise of employees' stock options.
- (d) During the first quarter of fiscal 2005, the Company completed a private placement for 4,000,000 Units. Each Unit cost \$0.70 and consisted of one common share and one-half common share purchase warrant. Each whole common share purchase warrant is exercisable at \$0.85 and expires on September 23, 2005.
- (e) During the first quarter of fiscal 2005, the Company issued a Compensation Option to the underwriter to purchase 300,000 Units at \$0.70 per Unit. Each Compensation Option Unit consists of one common share and one-half common share purchase warrant. Each whole common share purchase warrant is exercisable at \$0.85 and expires on September 23, 2005. The cost of the Compensation Option Units, in the amount of \$183,849, is included in financing costs. Of this total, \$69,841 was allocated to the issuance of warrants and the remaining \$114,008 was allocated to stock based compensation. These options expire on September 23, 2005.

**PACIFIC SAFETY PRODUCTS INC.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2004 AND SEPTEMBER 30, 2003**

**5. EQUITY INSTRUMENTS (continued)**

(f) During the first quarter of fiscal 2005, 92,000 common shares were issued at a weighted average price of \$0.44 per share through the exercise of employee's stock options.

**Stock Options**

The Company has a stock option plan that provides options to purchase common shares of the Company for its management, executive officers and members of the Board of Directors. These options expire five years after the issue date or 30 days after the executive officer's or manager's services to the corporation cease. Board of Directors member's options expire 90 days after termination or resignation. The exercise price for these stock options is set at the average closing price over the previous twenty-day trading period and the options are fully vested for employees when issued, except for the 100,000 options issued to an executive officer during the quarter. These options vest twelve months after the date of issue. Options granted to members of the Board of Directors vest twelve months after issue. At September 30, 2004, the Company had 858,000 stock options outstanding with exercise prices ranging from \$0.26 to \$1.20. Of the options issued at September 30, 2004, 100,000, with a weighted average exercise price of \$1.20, do not fully vest until September 30, 2005.

|  | <i>Management<br/>And Employees</i> | <i>Senior<br/>Management</i> | <i>Executive<br/>Officers</i> | <i>Board of<br/>Directors</i> | <i>Total</i>    | <i>Weighted<br/>Average<br/>Exercise<br/>Price</i> |
|--|-------------------------------------|------------------------------|-------------------------------|-------------------------------|-----------------|--|
| Balance, June 30, 2004   | 151,000                             | 10,000                       | 370,000                       | 319,000                       | 850,000         | \$ 0.38  |
| <b>Issued</b>  | -                                   | -                            | <b>100,000</b>                | -                             | <b>100,000</b>  | <b>\$ 1.20</b>                                     |
| <b>Expired</b>   | -                                   | -                            | -                             | -                             | -               | \$ -   |
| <b>Exercised</b>   | <b>(82,000)</b>                     | <b>(10,000)</b>              | -                             | -                             | <b>(92,000)</b> | <b>\$ 0.44</b>                                     |
| <b>September 30, 2004</b>                                      | <b>69,000</b>                       | <b>-</b>                     | <b>470,000</b>                | <b>319,000</b>                | <b>858,000</b>  | <b>\$ 0.47</b>                                     |
| <b>Weighted Average Exercise Price</b>                         | <b>\$ 0.48</b>                      | <b>\$ 0.43</b>               | <b>\$ 0.53</b>                | <b>\$ 0.37</b>                | <b>\$ 0.47</b>  |  |
| <b>Weighted Average Remaining<br/>Contractual Life (years)</b> | <b>1.26</b>                         | <b>-</b>                     | <b>3.51</b>                   | <b>3.49</b>                   | <b>3.32</b>     |  |

The fair value of stock options in previous years was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility (0.09), risk-free interest rate (5.0%), and weighted average life of five years. The fair value of stock options in the current quarter was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility (0.13), risk-free interest rate (1.85%), and weighted average life of one year.

**Stock Compensation**

As of July 1, 2004, the Company records compensation expense when stock options are issued to employees, officers or directors in accordance with CICA Handbook Section 3870.

**Common Share Purchase Warrants**

During the quarter, the Company completed a private placement by issuing 4,000,000 Units at \$0.70 per Unit. Each Unit consists of one common share and one-half common share purchase warrant. There are 1,999,998 whole common share purchase warrants outstanding at September 30, 2004. Each whole common share purchase warrant is exercisable at \$0.85 and expires September 23, 2005.

**6. BONUS INTEREST ON SUBORDINATED DEBENTURE**

As part of the terms of a \$2,000,000 subordinated debenture with its lender, the Company is required to pay bonus interest at the end of the five-year term or, if the subordinated debenture is paid out prior to maturity, on the date the final payment is made to them. The bonus interest payment will be equal to 20% of the greater of: (a) EBITDA for the most recently completed fiscal year at the end of the term of the loan; and (b) EBITDA for the average of the two highest fiscal years during the term of the subordinated debenture. The EBITDA calculation is based on the audited financial statements of the Company.

Management will provide for this future interest payment during the term of the subordinated debenture by calculating an estimate, deducting the interest accrued to that date, and dividing by the number of years left in the term. On this basis, the current estimate for the bonus interest payment to the lender is \$493,126. This accrual will be reviewed annually once the audited financial statements are available and amended if necessary. It is intended that the bonus interest will be fully provided for by the date it is actually payable to the lender. Management has increased the accrual to \$27,000 for the quarter ended September 30, 2004, from \$15,000 per quarter during the previous year, and expects to record the same amount during each of the next three quarters. The total amount accrued is now \$87,000.

**7. RELATED PARTY TRANSACTIONS**

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During the quarter the Company paid \$13,121 (September 30, 2003 - \$7,390) in fees to a member of the Board of Directors and to an organization related to another member of the Board of Directors. These fees were charged to general administration expense or capitalized as patents and trademarks on the balance sheet. These transactions were all in the normal course of operations and are measured at the exchange value (the amount of consideration established and agreed to by the related parties), which approximates the arm's length equivalent value.

Also during the quarter, several insiders of the Company participated in the private placement equity financing. Of the 4,000,000 Units purchased, 85,700 Units were purchased by insiders for gross proceeds of \$59,990.

**8. FINANCIAL INSTRUMENTS**

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As disclosed in note 1, the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate risk and foreign currency risk. The Company manages its exposure to these risks by operating in a manner that minimizes its exposure to the extent practical.

- (a) At September 30, 2004, the Company had \$2,287,000 (June 30, 2004 - \$2,332,000, September 30, 2003 - \$2,458,000) of long-term floating rate debt.
- (b) At September 30, 2004, the Company had \$- (June 30, 2004 - \$1,171,392, September 30, 2003 - \$-) of current floating rate debt.
- (c) At September 30, 2004, the Company had no significant individual accounts receivable outstanding.
- (d) At September 30, 2004, the Company had \$936,760 in cash on deposit with one financial institution.
- (e) Foreign currency exchange rate risk management - a portion of the Company's sales and purchases are denominated in foreign currencies and, accordingly, the related financial assets and liabilities are subject to fluctuations in exchange rates. The Company manages its exposure to foreign currency fluctuations by maintaining foreign currency bank accounts, receivables and payables to offset foreign transactions.

**9. SUBSEQUENT EVENTS**

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On October 8, 2004, the Company secured a letter of credit with its bank in the amount of \$649,339. The Company was required to provide the Department of Public Works and Government Services Canada contract financial security as a performance guarantee for the delivery of 34,568 fragmentation protective vests to Canada's Department of National Defence. The Company has used cash and cash equivalents as security for this letter of credit.

Subsequent to the quarter end, a cash sweep payment in the amount of \$150,000 was made to its lender as a required repayment of the unsecured subordinated debenture.

**10. COMPARATIVE FIGURES**

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Certain of the prior period's comparative figures have been reclassified to conform to the current period's presentation.



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