



**Pacific Safety Products Inc.**

PSP: TSX Venture Exchange  
www.pacsafety.com

# Investor Report

## Quarter One Fiscal 2007

For the First Quarter Ended September 30, 2006  
with Comparative Results for September 30, 2005

### Message to Shareholders

#### Review

Pacific Safety Products Inc. announced financial results for its first quarter of fiscal 2007. For the quarter ending September 30, 2006, the Company reported, on a consolidated basis, net income before tax of \$553,005 on revenue of \$8,918,945. The Company also disclosed net income before tax in its Canadian operation of \$944,000. This was partially offset by start up costs of \$439,000 in its U.S. operation. On an after tax basis, the Company reported \$242,497 of income or \$.013 per share. EBITDA for the quarter ended September 30, 2006 was \$803,666 compared to (\$687,521) in the comparable quarter last year, an improvement of \$1.49 million.

#### The Future

CEO and Chairman David E Scott said "These results are in line with our plan for fiscal 2007. We continue to see strong demand for our products and our order backlog remains very strong. As a result of our backlog and the global demand for armour and anticipated new contracts later this fiscal year we are updating our guidance for fiscal year 2007 on revenue to between \$35M to \$39M and net income before tax to \$2.0M to \$2.2M. We will continue each quarter to update this guidance."

On behalf of the PSP Management team,

David E. Scott

A handwritten signature in black ink, appearing to read "David E. Scott".

Chairman and Chief Executive Officer  
Pacific Safety Products Inc.

## MANAGEMENT DISCUSSION AND ANALYSIS

### Mission

*...we bring everyday heroes home safely.™*

The following discussion is intended to assist readers in better understanding and evaluating Pacific Safety Products ("PSP" or the "Company") history, business environment, strategies, performance and risk factors as well as the financial condition and operations for the quarter ended September 30, 2006. It is recommended the information provided be read in conjunction with PSP's consolidated financial statements and notes for the quarter ended September 30, 2006 and the consolidated financial statements and notes for the year ended June 30, 2006, message to shareholders and other management discussions included in the Company's 2006 annual report. The information in this report includes information available to November 21, 2006, 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. Unless otherwise indicated all dollar amounts shown are expressed in Canadian dollars.

Management is responsible for the preparation and integrity of the consolidated financial statements, including maintenance of appropriate information systems, procedures and internal controls, and to ensure that information used internally or disclosed externally, including the consolidated financial statements and management's discussion and analysis, is complete and reliable.

### OVERVIEW OF THE BUSINESS

PSP is an established industry leader in the development, production, distribution and sale of high-performance and high-quality protective products for the defence and security market. These products include body armour to protect against ballistic, stab and fragmentation threats, ballistic blankets to reduce blast effects, and protective products against ChemBio hazards. PSP is the largest armour manufacturer in Canada and supplies its products to the Canadian Department of National Defence, federal government agencies and major law enforcement organizations across the country. The Company, through its subsidiary Sentry Armor Systems Inc., provides body armour products to U.S. based law enforcement and private security firms.

The Company provides quality protection solutions by effectively integrating the latest technologies to serve our customers' needs. Founded in 1984, PSP has grown to include more than 280 employees at our Canadian and U.S. facilities. These facilities are equipped with complete design, production and research capabilities.

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).

### Market Conditions

The defence industry sector serviced by PSP products is experiencing significant expansion as a result of on-going military engagements by NATO including Afghanistan and heightened risk of terrorist events. Concern for the protection of deployed forces has driven demand for tactical armour and fragmentation protection for both people and equipment. PSP continues to provide tactical armour and load carriage equipment to various units of Canada's Department of National Defence (DND). Under DND's Clothe the Soldier Program, PSP is delivering Fragmentation Protection Vests and the Horizon 1 Chem/Bio Coveralls. Two contract amendments were issued over the past year increasing quantities on the Fragmentation Protection Vest Contract. DND is also moving forward with its Integrated Soldier System Program (ISSP) which is intended to improve situational awareness for the dismantled soldier.

PSP enjoys a dominant position in the Canadian domestic market for law enforcement and private security. The Company is experiencing steady demand within this well established market. In addition, PSP has seen strong growth in the requirement for body armour for new customers such as the Canadian Border Services and various correctional agencies.

Demand for soft armour products remains strong in the United States. To better address this market, PSP has established a U.S. subsidiary, Sentry Armor Systems Inc. Sentry will sell and manufacture tactical clothing and soft armour based on the PSP product line.

Given current industry and market conditions, together with increasing international tensions, demand for products serving the security and defense sector is expected to grow steadily. PSP is prepared and positioned to provide effective protective solutions for its customers by using the latest technologies to serve their needs.

### OVERALL CORPORATE PERFORMANCE

The Company recorded net income before taxes of \$553,005 for the first quarter of fiscal 2007. This compares to a net loss of \$998,777 in the same quarter last year. The current quarter's net income includes the results of operations of the Company's U.S. subsidiary, Sentry Armor Systems Inc. (Sentry) which began operations in July 2006. Sentry opened its doors on July 5, 2006 and began hiring and training on production, quality, safety, product development and materials management. Capital equipment to support the production of tactical clothing and concealable body armour was purchased and installed and the Company shipped its first order at the beginning of August.

For purposes of comparing current quarter results to last year's first quarter results, the Company reported current quarter net income before taxes from the Canadian operations of \$990,637 and a loss of \$437,632 from the Company's U.S. operations for a net consolidated income before taxes of \$553,005.

### CONSOLIDATED RESULTS OF OPERATIONS

The Company reported income after taxes of \$242,497 for the quarter ended September 30, 2006 compared to a loss after taxes of \$1,026,492 for the quarter ended September 30, 2005, an improvement of \$1,268,989. The Company reported sales for the quarter of \$8.9 million, up from \$6.4 million last year.

<b>SUMMARY OF OPERATIONS</b>	<b>THREE MONTHS ENDED SEPTEMBER 30, 2006</b>	<b>THREE MONTHS ENDED SEPTEMBER 30, 2005</b>
<b>SALES</b>	<b>\$ 8,918,945</b>	<b>\$ 6,417,774</b>
<b>COST OF SALES</b>	<b>6,782,501</b>	<b>5,141,633</b>
<b>GROSS MARGIN</b>	<b>2,136,444</b>	<b>1,276,141</b>
<b>EXPENSES</b>	<b>1,506,503</b>	<b>1,593,690</b>
<b>OTHER ITEMS</b>	<b>76,936</b>	<b>681,228</b>
<b>TOTAL EXPENSES AND OTHER ITEMS</b>	<b>1,583,439</b>	<b>2,274,918</b>
<b>INCOME (LOSS) BEFORE INCOME TAXES</b>	<b>553,005</b>	<b>(998,777)</b>
<b>INCOME TAX EXPENSE</b>	<b>310,508</b>	<b>27,715</b>
<b>INCOME (LOSS)</b>	<b>\$ 242,497</b>	<b>\$ (1,026,492)</b>
<b>BASIC AND FULLY DILUTED INCOME (LOSS) PER SHARE</b>	<b>\$ 0.013</b>	<b>\$ (0.054)</b>
<b>WEIGHTED AVERAGE BASIC COMMON SHARES ISSUED AND OUTSTANDING</b>	<b>19,168,444</b>	<b>18,954,673</b>

#### Sales

PSP recorded \$8.9 million in sales for the quarter ended September 30, 2006, which represents an increase of \$2.5 million, or 39% over last year's quarter one sales. Revenue from the two major government contracts amounted to \$5.97 million or 67% of the total Canadian government revenue and the remaining balance of \$998,586 relates to other federal government sales.

#### Gross Margin

Gross margin for the quarter improved to 24% of revenue as compared to 20% in the same period last year. The gross margin is consistent with management's expectations as the labour pool gained efficiencies over the last year. Increased revenue levels results in fixed manufacturing overhead costs contributing to a smaller portion of the total costs of sales. The gross margin of 24% also included \$186,196 of gross margin costs associated with the start up of Sentry Armor Systems factory in Tennessee, USA.

#### Selling, Research and General Administration Expenses

The total of these expenses for the quarter was \$1,506,503 compared to \$1,593,690 last year, a decrease of \$87,187. As a percentage of revenue, these expenses decreased significantly to 16.89% compared to 24.83% in the same quarter last year. General and administration expenditures increased \$204,061 to \$814,655 compared to \$610,594 last year. As a percentage of revenue these costs represent 9.13% and 8.36% respectively of general and administration expense. This increase is a result of a reclassification of insurance expenses of \$55,607 to general and administration expense and an increase of costs of \$146,000 relating to outside consultants and wages.

Research and development expenditures for the quarter totaled \$83,936 for the year compared to \$191,767 last year, a decrease of \$107,831. During the quarter, management deferred \$43,098 in R&D costs relating to new product development projects that have known markets and are expected to come into commercial production at a future date. Expenses included in this category include the costs related to ballistic research materials, testing, product designs, patterns, labour and overhead.

Amortization of property, plant and equipment decreased \$1,957 to \$65,236 in Q1 compared to \$67,193 in the same period last year. Amortization of other assets increased \$16,882 to \$66,145 compared to \$49,263 in quarter one, fiscal 2006 due to an increase in deferred product development costs and start up costs relating to Sentry Armor Systems Inc.

There was no interest calculated on the operating line for the three months ended September 30, 2006. This compares to \$2,635 in the same quarter last year.

Interest on long-term debt decreased \$64,292 to \$76,936 compared to \$141,228 last year. The decrease is the result of management's successful negotiation in the previous year of an additional principal payment and an early payment of a bonus interest requirement on the subordinated debenture. Included in last year's Q1 expense was \$27,000 for the accrual of the EBITDA bonus interest of which there is none required in the current quarter as it was fully paid out in fiscal 2006. The balance of the subordinated debenture at the end of this quarter is \$800,000 compared to \$1.85 million at the end of the same quarter last year.

#### Restructuring Expenses

There were no restructuring expenses in the current quarter, compared to the same quarter last year which related to corporate

restructuring including the closure of the Brampton, ON facility. These expenses were recorded separately on the income statement as they were deemed by management to be one-time costs that were not reflective of current operations and were not expected to be incurred in future periods.

#### Income Taxes

Income taxes was calculated at an effective rate of 34.12% for Canadian operations and 16.63% for U.S. operations for the quarter ended September 30, 2006. Income tax expense on Canadian earnings for the current quarter varies from the amount that would be computed by applying the combined federal and provincial tax rate as a result of tax losses available to reduce future income taxes payable and the tax effect of items not deductible for tax purposes. The future tax benefit of the U.S. losses has not been recorded in quarter one due to the lack of earnings history to support recognition at this time.

#### Income (Loss) after Taxes

The Company reported income after taxes of \$242,497 compared to a loss after taxes of \$1,026,492 in quarter one of fiscal 2006.

#### Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)

EBITDA for the quarter ended September 30, 2006 was \$803,666 compared to \$(687,521) for the quarter ended September 30, 2005.

### CONSOLIDATED QUARTERLY RESULTS

	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006	Q4 2005	Q3 2005	Q2 2005
Sales	\$8,918,945	\$9,369,317	\$9,195,213	\$7,204,500	\$6,417,774	\$6,010,002	\$5,367,417	\$2,938,423
Net income (loss)	\$242,497	\$741,766	\$742,182	\$520,055	(\$1,026,492)	(\$1,621,985)	\$30,620	(\$581,749)
Basic and fully diluted earnings (loss) per share	\$0.013	\$0.038	\$0.039	\$0.027	(\$0.054)	(\$0.086)	\$0.002	(\$0.035)

The Company has reported positive earnings for the previous four quarters. In Q1 of 2006, the Company underwent a significant corporate restructuring which resulted in a one-time expense of \$540,000 being recorded in the quarter. The loss in Q4 of 2005 was the result of management's assessment of several projects that were deemed to have no future benefit and were subsequently written off.

#### Cash Flow

Cash flow generated from operating activities was \$295,845 compared to \$562,381 of cash used in the same quarter last year, using the direct method under generally accepted accounting principles. The increase in cash generated from operations relates mainly to increased revenue and lower expenses. The Company invested \$178,782 in new product development, intangible assets and property, plant and equipment compared to \$87,812 in quarter one of fiscal 2006. These costs relate mainly to the start up of operations of the U.S. subsidiary. Financing activities decreased cash by \$461,292 compared to \$195,733 in the same quarter, last year. The Company opted to pay the maximum principal repayment of \$400,000 on the subordinated debenture due in July 2006 compared to a principal repayment of \$200,000 paid in July 2005.

<b>CASH FLOW</b>	<b>THREE MONTHS ENDED SEPTEMBER 30, 2006</b>	<b>THREE MONTHS ENDED SEPTEMBER 30, 2005</b>
Cash flow from (used for) continuing operations	\$ 295,845	\$ (562,381)
Investing activities and capital expenditures	\$ (178,782)	\$ (87,812)
Financing activities	\$ (461,292)	\$ (195,733)
	\$ (344,229)	\$ (845,926)

### LIQUIDITY AND CAPITAL RESOURCES

#### FINANCIAL POSITION

	<b>THREE MONTHS ENDED SEPTEMBER 30, 2006</b>	<b>THREE MONTHS ENDED JUNE 30, 2006</b>
Cash and cash equivalents (bank indebtedness)	\$ 1,788,657	\$ 2,132,886
Working capital	\$ 5,371,266	\$ 5,581,621
Long-term debt (long-term portion only)	\$ 2,072,031	\$ 2,532,000
Shareholders' equity	\$ 10,052,101	\$ 9,812,233

#### WORKING CAPITAL

At September 30, 2006, PSP's working capital position was \$5,371,266 compared to \$5,581,621 at September 30, 2005. PSP has enough working capital to meet current commitments and deliver current and future orders. PSP expects to generate significant cash flow from operations based on current orders in place.

#### Bank Indebtedness

The amount drawn on the bank operating line was \$ nil compared to \$861,518 at September 30, 2005.

## **Bank Covenants**

At September 30, 2006, the Company was compliant with all covenants set out by its lenders.

## **Investment Tax Credits Receivable**

The Company has \$477,763 in investment tax credits receivable recorded at September 30, 2006 relating to scientific research and development expenses incurred in previous periods. These credits were recorded as a reduction to research and development expenses on the income statement.

## **Future Income Tax Assets**

At September 30, 2006, PSP had accumulated approximately \$929,025 in Canadian non-capital tax loss carry forwards available to be used against future taxable income. Of the \$406,934 in future tax assets recorded on the balance sheet, PSP has recorded current future income taxes recoverable of \$153,971 at September 30, 2006 (June 30, 2006 - \$468,656). This has been recorded as a current asset because forecasts based on the current order book and shipment schedule of the FPV and H1 contracts for the Canadian Military are expected to provide enough taxable income to use up loss carry forwards in the next fiscal year. Loss carry forwards for the U.S. operation, Sentry Armor Systems Inc, have not been recorded in this quarter due to the lack of earnings history to support these loss carry forward assets being recognized at this time. Future tax assets of both the Canadian and U.S. operations will be assessed on a quarterly basis.

## **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 invested \$94,877 in property, plant and equipment, \$43,098 in new product development costs and \$40,807 in patents, trademarks and deferred start up costs. In July 2006, the Company began operations in its U.S. subsidiary, Sentry Armor Systems Inc. The majority of the property, plant and equipment purchased in quarter one related to ramping up for production in Sentry.

## **LONG-TERM DEBT**

The Company made regular principal and interest repayments on the secured debenture and made the maximum principal repayment of \$400,000 on the secured debenture on July 14, 2006. Between September 30, 2005 and September 30, 2006 the Company has reduced the balance of the subordinated debenture by \$1,050,000; all funded by cash generated from operations.

## **Equity Instruments and Contributed Surplus**

During the quarter, PSP issued 5,265 shares under its Employee Share Ownership Plan for net proceeds of \$2,365. A Board member exercised 15,000 stock options for the issue of 15,000 common shares with a weighted average exercise price of \$0.29 per share for proceeds of \$4,350. At September 30, 2006, PSP's issued and outstanding shares totaled 19,175,756 compared to 19,155,491 at June 30, 2006.

## **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, 2006.

## **Related Party Transactions**

During the quarter, PSP paid \$46,816 (September 30, 2005 - \$873) in professional 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.

## **Financial Instruments**

As disclosed in note 2 and 10 of the Q1 financial statements, the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate, credit 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, 2006, the Company had \$1,894,000 (June 30, 2006 - \$1,948,000) of long-term floating rate debt.
- (b) At September 30, 2006, the Company had nil (June 30, 2006 - nil) of current floating rate debt.
- (c) At September 30, 2006 the Company had \$2,570,115 (June 30, 2006 - \$1,894,461) in accounts receivable due from the Canadian Federal government.
- (d) At September 30, 2006 the Company had \$1,682,657 (June 30, 2006 - \$2,390,830) cash on deposit with a Canadian Chartered Bank and \$174,591 cash on deposit with a U.S. Bank.
- (e) At September 30, 2006 the Company held a secured letter of credit with its financial institution in the amount of US\$750,000.
- (f) Foreign currency exchange rate risk management - a portion of the Company's sales 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 and receivables to offset foreign currency payables and planned expenditures. The effect of a 1% change in foreign currency exchange rates would have a nominal effect on the financial results of the Company.
- (g) At September 30, 2006, the Company had available to it Canadian non-capital tax loss carry forwards of approximately

\$929,000 of which \$153,971 has been recognized as a current future income tax asset. The Company has U.S. tax loss carry forwards of approximately \$367,824 which have not been recognized (June 30, 2006 - Canadian non-capital tax loss carry forwards of \$1.8 million of which \$468,656 were recognized, U.S. tax loss carry forwards were nil).

### **Disclosure Controls and Procedures**

During the current quarter, management reviewed the existing disclosure controls and procedures and, based on that review, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective.

### **Risks and Uncertainties**

In the normal course of business, the Company's operations continue to be influenced by a number of internal and external factors, and are exposed to risks and uncertainties, that can affect its business, financial condition and operating results. The activities of the Company are subject to ongoing operational risks including the performance of key suppliers, product performance, government and other industry regulations, and reliance on information systems, all of which may affect the ability of the Company to meet its obligations. The ongoing ability to meet the needs of the market place is dependent on the development and introduction of new products. While management believes its innovation and technology make it a leader in the industry, revenue and results may be affected if products are not accepted in the market place, are not approved by regulatory authorities, or if products are not brought to market in a timely manner.

PSP operates in markets subject to government purchasing patterns and large tenders that are at times unpredictable and create fluctuations in the production load throughout the year. Government purchasing is typically tender driven and subject to competitive bidding. These buying patterns create the necessity of being able to quickly increase and decrease production capacity. PSP has addressed this by using cell based manufacturing in which production staff are grouped into cells. Cells can quickly be added or reduced in order to mitigate the impact of large contracts on regular production of core products. In addition, large contracts often create a situation where a significant portion of the Company's revenue and accounts receivable may be from a small number of customers increasing the risks of economic dependence and concentration of credit.

The Company's working capital position is dependent on the timely collection of accounts receivable, inventory management and scheduled supplier payments. A change in supplier payment terms or slow payment of accounts receivable could adversely affect the Company's liquidity. Management has implemented controls to ensure accounts receivable are current and suppliers payments are within terms.

Changing interest rates could have an effect on earnings. A total of \$1,894,000 of PSP's long-term debt is subject to variable interest rates. In addition, PSP's operating line, with a balance of nil at September 30, 2006, is also a variable rate loan. Foreign exchange rate fluctuations could lead to differences in the profitability of international contracts and orders. The majority of large international contracts are bid months in advance of when they are manufactured and shipped. These contracts are typically priced using United States dollars at an estimated future foreign exchange rate. If awarded to PSP, the receivables will generally be insured or secured by a letter of credit to ensure payment. If deemed necessary, management will enter into a foreign exchange forward contract to lock in the foreign exchange rate over the period of performance of these contracts. In addition, PSP reviews its price lists on a regular basis to ensure that it diminishes its exposure to rate changes. PSP manages its ongoing foreign currency exchange exposure by maintaining foreign currency bank accounts and receivables to offset foreign currency payables and planned expenditures. The nature of PSP's business allows the Company to naturally hedge future normal foreign currency payments with future normal foreign currency collections.

PSP has significant investment tax credits and income tax loss carry forward amounts available. These items are subject to review and assessment by Canadian Income Tax authorities and could cause future adjustments to earnings.

### **OUTLOOK**

PSP began operations in the U.S. through its subsidiary, Sentry Armor Inc. (Sentry) located in Dover, Tennessee. Sentry is producing both armour and tactical clothing products. Establishing a manufacturing facility in the U.S. enables the Company to bid on U.S. Department of Defence contracts that were previously unavailable to PSP as a Canadian manufacturer.

The Company has been awarded a contract from Canada Corrections with a value of \$1.4M to provide protective vests. This contract is the second large contract won by PSP in the past nine months in the developing corrections market. A portion of this contract will be completed at Sentry.

During the quarter, PSP has worked with a number of customers developing ballistic blanket designs. Applications include vehicle armour for protection against blast, mining equipment armour to reduce damage from catastrophic failure and high voltage splice armour to protect adjacent equipment in underground installations.

### **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 (earnings before interest, income taxes, depreciation and amortization), 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

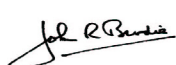
expenditures and financial results are forward looking statements. Some of the forward looking statements may be identified by words like "expects," "anticipates," "plans," "intends," "projects," "indicates," and similar expressions. These statements are not guarantees of future performance and involve 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.  
CONSOLIDATED BALANCE SHEETS**

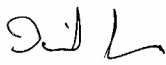
<b>As at</b>	<b>September 30, 2006 (unaudited)</b>	<b>June 30, 2006 (audited)</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 1,788,657	\$ 2,132,886
Accounts receivable (note 10)	4,058,607	3,749,043
Inventory (note 3)	4,879,604	4,913,302
Prepaid expenses and deposits	453,508	387,654
Investment tax credits receivable	477,763	440,263
Future income taxes recoverable	153,971	468,656
<b>Total Current Assets</b>	<b>11,812,110</b>	<b>12,091,804</b>
<b>FUTURE INCOME TAXES RECOVERABLE</b>	<b>252,963</b>	<b>267,767</b>
<b>PROPERTY, PLANT AND EQUIPMENT</b>	<b>3,102,328</b>	<b>3,115,031</b>
<b>OTHER ASSETS</b>	<b>264,039</b>	<b>233,817</b>
<b>INTANGIBLE ASSETS</b>	<b>299,183</b>	<b>311,644</b>
<b>GOODWILL</b>	<b>2,834,353</b>	<b>2,834,353</b>
<b>TOTAL ASSETS</b>	<b>\$ 18,564,976</b>	<b>\$ 18,854,416</b>
<b>LIABILITIES</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities	4,614,639	4,993,746
Deferred revenue	1,166,814	849,008
Current portion of long-term debt	659,391	667,429
<b>Total Current Liabilities</b>	<b>6,440,844</b>	<b>6,510,183</b>
<b>LONG-TERM DEBT</b>	<b>2,072,031</b>	<b>2,532,000</b>
<b>TOTAL LIABILITIES</b>	<b>8,512,875</b>	<b>9,042,183</b>
<b>SHAREHOLDERS' EQUITY</b>		
<b>EQUITY INSTRUMENTS</b> (note 4)	<b>11,848,562</b>	<b>11,860,828</b>
<b>CONTRIBUTED SURPLUS</b> (note 5)	<b>713,448</b>	<b>703,811</b>
<b>DEFICIT</b>	<b>(2,509,909)</b>	<b>(2,752,406)</b>
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>10,052,101</b>	<b>9,812,233</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 18,564,976</b>	<b>\$ 18,854,416</b>

Contingencies and commitments (Note 8 )

**ON BEHALF OF THE BOARD OF DIRECTORS:**



John Brodie, Director



David Scott, Director

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

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

<i>For the Three Months Ended September 30th</i>	<i>2006</i>	<i>2005</i>
<b>SALES</b> (note 6)	<b>\$ 8,918,945</b>	<b>\$ 6,417,774</b>
<b>COST OF SALES</b>		
Amortization of property, plant and equipment	42,344	53,572
Materials, labour and manufacturing overhead	6,740,157	5,088,061
Total Cost of Sales	6,782,501	5,141,633
<b>GROSS MARGIN</b>	<b>2,136,444</b>	<b>1,276,141</b>
<b>EXPENSES</b>		
Sales and marketing	465,678	746,551
Research and development	83,936	191,767
General and administration	814,655	610,594
Interest on operating line	-	2,635
Foreign exchange (gains) losses	10,853	(74,313)
Amortization of property, plant and equipment	65,236	67,193
Amortization of intangible and other assets	66,145	49,263
Total Expenses	1,506,503	1,593,690
<b>INCOME (LOSS) BEFORE OTHER ITEMS</b>	<b>629,941</b>	<b>(317,549)</b>
<b>OTHER ITEMS</b>		
Periodic interest on long-term debt	76,936	114,228
Bonus interest on subordinated debenture	-	27,000
Restructuring expenses (note 7)	-	540,000
<b>TOTAL OTHER ITEMS</b>	<b>76,936</b>	<b>681,228</b>
<b>NET EARNINGS (LOSS) BEFORE INCOME TAXES</b>	<b>553,005</b>	<b>(998,777)</b>
<b>FUTURE INCOME TAXES</b>	<b>310,508</b>	<b>27,715</b>
<b>NET INCOME (LOSS)</b>	<b>242,497</b>	<b>(1,026,492)</b>
<b>DEFICIT, BEGINNING</b>	<b>(2,752,406)</b>	<b>(3,729,917)</b>
<b>DEFICIT, ENDING</b>	<b>\$ (2,509,909)</b>	<b>\$ (4,756,409)</b>
<b>BASIC AND FULLY DILUTED EARNINGS</b> <b>(LOSS) PER SHARE</b> (note 4)	<b>\$ 0.013</b>	<b>\$ (0.054)</b>
<b>WEIGHTED AVERAGE BASIC COMMON</b> <b>SHARES ISSUED AND OUTSTANDING</b>	<b>19,168,444</b>	<b>18,954,673</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 September 30th</b>	<b>2006</b>	<b>2005</b>
<b>OPERATING ACTIVITIES</b>		
Cash receipts from customers	\$ 8,889,687	\$ 7,197,800
Cash paid to suppliers and employees	(8,516,906)	(7,643,318)
Interest paid	(76,936)	(116,863)
<b>CASH FLOW FROM (USED BY) OPERATING ACTIVITIES</b>	<b>295,845</b>	<b>(562,381)</b>
<b>INVESTING ACTIVITIES</b>		
Purchase of property, plant and equipment	(94,877)	(86,002)
Investment in new product development	(43,098)	-
Investment in intangible assets	(40,807)	(1,810)
<b>CASH FLOW USED BY INVESTING ACTIVITIES</b>	<b>(178,782)</b>	<b>(87,812)</b>
<b>FINANCING ACTIVITIES</b>		
Repayment of long-term debt	(468,007)	(238,446)
Proceeds from the issue of equity instruments	6,715	42,713
<b>CASH FLOW USED BY FINANCING ACTIVITIES</b>	<b>(461,292)</b>	<b>(195,733)</b>
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(344,229)</b>	<b>(845,926)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING</b>	<b>2,132,886</b>	<b>711,562</b>
<b>CASH AND CASH EQUIVALENTS, ENDING</b>	<b>\$ 1,788,657</b>	<b>\$ (134,364)</b>
<b>REPRESENTED BY:</b>		
Cash and cash equivalents	\$ 1,788,657	\$ 727,154
Bank indebtedness	-	(861,518)
<b>Cash and cash equivalents</b>	<b>\$ 1,788,657</b>	<b>\$ (134,364)</b>

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

**1. NATURE OF ACTIVITIES**

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Pacific Safety Products Inc., incorporated under the Business Corporations Act, manufactures, distributes and sells a complete line of protective products and accessories for the defence and security market. Nexus Armour Inc. is a wholly owned subsidiary of PSP and is the parent company of Sentry Armor Systems Inc. (Sentry). Sentry was incorporated under the State of Delaware, USA. and commenced operations in Dover, Tennessee on July 5, 2006.

**2. SIGNIFICANT ACCOUNTING POLICIES**

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**Basis of Presentation**

The accompanying consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and includes the accounts of Pacific Safety Products Inc. and its controlled companies, Nexus Armour Inc. and Sentry Armor Systems Inc. All intercompany transactions and balances are eliminated on consolidation.

These interim unaudited consolidated financial statements follow the same accounting policies and methods of application as the most recent audited consolidated financial statements dated June 30, 2006. The disclosures provided herein are incremental to those included in the audited annual consolidated financial statements. These interim unaudited consolidated financial statements should be read in conjunction with the Company's June 30 ,2006 audited annual 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 consolidated financial statements. Actual results may differ from those estimates.

**Foreign Currency Translation**

The Company follows the temporal method of accounting for the translation of foreign currency amounts into Canadian dollars as Sentry Armor Systems Inc. is an integrated foreign operation. Under this method, monetary assets and liabilities denominated in foreign currencies are translated at the exchange rates in effect at the balance sheet date. Non-monetary assets are translated at the historical rate of exchange. Revenue and expenses are translated at the rates of exchange prevailing on the transaction date. Gains and losses on translation are reflected in the statement of operations.

**Measurement Uncertainty**

The amounts accrued to recognize investment tax credits and future income tax assets relating to unclaimed loss carry-forwards for income tax purposes are based on the Company's estimate that it will have sufficient future taxable income to utilize these losses. By their nature, these estimates are subject to measurement uncertainty and the effects of changes in estimates of judgments will be recorded in the period such changes are made.

Goodwill is reviewed by management annually or more frequently if an event or circumstances indicate that the asset might be impaired. When the carrying amount of a reporting unit exceeds its fair value an impairment is recognized in operations. Impairment is measured as the shortfall of the reporting unit's projected cashflows, after allocation to specific assets and liabilities, compared with the carrying amount of goodwill.

Management assess intangible assets to ensure costs are recoverable through future sales. Any amount deemed to be unrecoverable are recognized in the current period. By their nature, these estimates are subject to measurement uncertainty and the effects of changes in estimates of judgments will be recorded in the period such changes are made.

The Company expenses warranty costs as they are incurred and management has determined that these costs are insignificant and have therefore not been provided for. This estimate is subject to measurement uncertainty and the effects of changes in estimates of judgments will be recorded in the period such changes are made.

**Comparative Figures**

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

**PACIFIC SAFETY PRODUCTS INC.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE QUARTER ENDED ENDED SEPTEMBER 30, 2006 AND SEPTEMBER 30, 2005**

<b>3. INVENTORY</b>	<b>September 30, 2006</b>	<b>June 30, 2006</b>
Raw materials	\$ 4,352,535	\$ 4,496,851
Work in process	293,460	237,312
Finished goods and samples	233,609	179,139
	<b>\$ 4,879,604</b>	<b>\$ 4,913,302</b>

**4. EQUITY INSTRUMENTS**

**Authorized**

The authorized share capital of the Company consists of unlimited voting common shares without par value.

	<b>Number of Shares</b>	<b>Amount</b>
Beginning balance, June 30, 2006	19,155,491	\$ 11,860,828
Employee Ownership Plan (a)	5,265	2,365
Exercise of options (b)	15,000	4,350
Recovery of stock issue costs (c)	-	(18,981)
<b>Balance, September, 2006</b>	<b>19,175,756</b>	<b>11,848,562</b>

**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 members' 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 20 day trading period. Vesting periods are determined by the Board of Directors upon issuance. At September 30, 2006, the Company had 1,077,430 stock options outstanding with exercise prices ranging from \$0.27 to \$1.95. Of the options outstanding at September 30, 2006, 155,000 do not fully vest until one year after the grant date and/or specific conditions have been satisfied.

	<b>Senior Management</b>	<b>Executive Officers</b>	<b>Board of Directors</b>	<b>Total</b>	<b>Weighted Average Exercise Price</b>
Balance, June 30, 2006	101,900	489,500	342,500	933,900	\$ 0.64
<b>Issued</b>	<b>22,000</b>	<b>100,000</b>	<b>50,000</b>	<b>172,000</b>	<b>\$ 0.68</b>
<b>Expired</b>	<b>(10,800)</b>	<b>(2,670)</b>	<b>-</b>	<b>(13,470)</b>	<b>\$ 0.68</b>
<b>Exercised</b>	<b>-</b>	<b>-</b>	<b>(15,000)</b>	<b>(15,000)</b>	<b>\$ 0.29</b>
<b>Balance, September 30, 2006</b>	<b>113,100</b>	<b>586,830</b>	<b>377,500</b>	<b>1,077,430</b>	<b>\$ 0.65</b>
<b>Weighted Average Exercise Price</b>	<b>\$ 0.69</b>	<b>\$ 0.58</b>	<b>\$ 0.75</b>	<b>\$ 0.65</b>	
<b>Weighted Average Remaining Contractual Life (years)</b>	<b>-</b>	<b>4.44</b>	<b>2.98</b>	<b>3.49</b>	<b>3.31</b>
<b>Total Stock Option Pool Authorized</b>					<b>2,000,000</b>
<b>Total Stock Option Pool Remaining</b>					<b>317,070</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 ranged from (0.71 to 0.74), risk-free interest rate ranged from (2.3% to 3.85%), and weighted average life of five years. The fair value of stock options in the current quarter estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility (0.65), risk-free interest rate (4.0%), and weighted average life of five years.

**PACIFIC SAFETY PRODUCTS INC.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE QUARTER ENDED ENDED SEPTEMBER 30, 2006 AND SEPTEMBER 30, 2005**

**4. EQUITY INSTRUMENTS (continued)**

The following table summarizes information regarding the Company's outstanding stock options at September 30, 2006.

Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$0.27 to \$0.39	400,000	1.66	\$ 0.34	400,000	\$ 0.34
\$0.46 to \$0.96	557,430	4.49	\$ 0.65	402,430	\$ 0.63
\$1.43 to \$1.95	120,000	0.73	\$ 1.71	120,000	\$ 1.71
	1,077,430		\$ 0.65	922,430	\$ 0.64

<b>Equity Instruments Outstanding</b>	<b>September 30, 2006</b>	<b>June 30, 2006</b>
Common shares, issued and outstanding	19,175,756	19,155,491
Stock options	1,077,430	933,900
Employee Share Ownership Plan	43,822	49,087
<b>Fully diluted equity instruments</b>	<b>20,297,008</b>	<b>20,138,478</b>

- (a) In the current quarter the Company issued 5,265 shares under its employee share ownership plan. Under the plan, employees were entitled to purchase up to 300,000 common shares at \$0.43 per share, which was the trading price at the time of offering.  
(b) During the quarter, 15,000 common shares were issued through the exercise of employee stock options for proceeds of \$4,350.  
(c) Stock issue costs previously recorded are recoverable over a five year period.

**5. CONTRIBUTED SURPLUS**

Balance, June 30, 2006	\$ 703,811
Stock option compensation expense (a)	9,637
<b>Balance, September 30, 2006</b>	<b>\$ 713,448</b>

(a) The fair value of stock options was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield (nil), expected volatility (0.65), risk-free rate (4.0%) and weighted average life of five years.

<b>6. DOMESTIC AND EXPORT SALES</b>	<b>Domestic</b>	<b>United States</b>	<b>International</b>	<b>Total</b>
<b>Fiscal 2007 Quarter One Sales</b>				
Law Enforcement Products	\$ 1,448,759	\$ 111,235	\$ 55,260	\$ 1,615,254
Government and Military Products	6,964,150	-	-	6,964,150
Emergency and Industrial Safety Products	89,089	211,465	38,987	339,541
	\$ 8,501,998	\$ 322,700	\$ 94,247	\$ 8,918,945
<b>Fiscal 2006 Quarter One Sales</b>				
Law Enforcement Products	\$ 1,417,212	\$ 153,507	\$ 14,735	\$ 1,585,454
Government and Military Products	4,338,013	-	-	4,338,013
Emergency and Industrial Safety Products	224,680	269,627	-	494,307
	\$ 5,979,905	\$ 423,134	\$ 14,735	\$ 6,417,774

The Company operates primarily in the protective products and accessories manufacturing and distribution industry. Its current operations are based in British Columbia and Ontario, Canada and in Tennessee, USA. Included in Q1 revenue were sales of \$6.96 million to the Canadian Federal Government (2006 Q1 - \$4.34 million) which represents 78% (2006 Q1 - 68%) of total sales. Other than the Canadian Federal Government, the Company had no other significant sales (over 10% of revenue) to any one customer.

**PACIFIC SAFETY PRODUCTS INC.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE QUARTER ENDED ENDED SEPTEMBER 30, 2006 AND SEPTEMBER 30, 2005**

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**7. RESTRUCTURING EXPENSES**

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On August 31, 2005 the Company announced a significant restructuring of the organization that included the resignation of several members of its Executive Leadership Team and the closure of its Brampton Facility. These costs were specifically associated with the exit and disposal activities of the reorganization of the Company. The total restructuring expenses incurred in the first quarter of fiscal 2006 comprised:

Severance and recruitment costs	\$405,547
Facility closure and other restructuring costs	134,453

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Balance, September 30, 2005	\$540,000
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**8. CONTINGENCIES AND COMMITMENTS**

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The Company has commitments to certain of its suppliers for purchase orders extending over a two-year period. The commitments total approximately \$10.5 million and are related to the purchase of raw materials for the two major government contracts.

**9. RELATED PARTY TRANSACTIONS**

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During the quarter the Company paid \$46,816 (September 30, 2006 - \$873) in professional 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. 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.

**10. FINANCIAL INSTRUMENTS**

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As disclosed in note 2, the Company holds various forms of financial instruments. The nature of these instruments and the Company's operations expose the Company to interest rate, credit 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, 2006, the Company had \$1,894,000 (June 30, 2006 - \$1,948,000) of long-term floating rate debt.
- (b) At September 30, 2006, the Company had nil (June 30, 2006 - nil) of current floating rate debt.
- (c) At September 30, 2006 the Company had \$2,570,115 (June 30, 2006 - \$1,894,461) in accounts receivable due from the Canadian Federal government.
- (d) At September 30, 2006 the Company had \$1,682,657 (June 30, 2006 - \$2,390,830) cash on deposit with a Canadian Chartered Bank and \$174,591 cash on deposit with a U.S. Bank.
- (e) At September 30, 2006 the Company held a secured letter of credit with its financial institution in the amount of US\$750,000.
- (f) Foreign currency exchange rate risk management - a portion of the Company's sales 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 and receivables to offset foreign currency payables and planned expenditures. The effect of a 1% change in foreign currency exchange rates would have a nominal effect on the financial results of the Company.
- (g) At September 30, 2006, the Company had available to it Canadian non-capital tax loss carry forwards of approximately \$929,000 of which \$153,971 has been recognized as a current future income tax asset. The Company has U.S. tax loss carry forwards of approximately \$367,824 which have not been recognized (June 30, 2006 - Canadian non-capital tax loss carry forwards of \$1.8 million of which \$468,656 were recognized, U.S. tax loss carry forwards were nil).



**Pacific Safety Products Inc.**

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