Kraken Robotics Inc.

Consolidated Financial Statements

For the years ended December 31, 2017 and 2016
(Expressed in Canadian Dollars)

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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Kraken Sonar Inc.

We have audited the accompanying consolidated financial statements of Kraken Sonar Inc., which comprise the consolidated statements of financial position as at December 31, 2017 and December 31, 2016, the consolidated statements of net loss and comprehensive loss, changes in shareholders' equity (deficiency) and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Kraken Sonar Inc. as at December 31, 2017 and December 31, 2016, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards**.**

Emphasis of matter

Without modifying our opinion, we draw attention to Note 2 to the consolidated financial statements which indicates that Kraken Sonar Inc., has experienced significant losses and negative cash flows from operations in 2017 and 2016 and has a deficit. These conditions, along with other matters as set forth in note 2 in the consolidated financial statements, indicate the existence of a material uncertainty that cast significant doubt about Kraken Sonar Inc.'s ability to continue as a going concern.

KPMG LLP

Chartered Professional Accountants
April 30, 2018
St. John's, Canada

December 31, 2017

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KRAKEN

Consolidated Statements of Financial Position
December 31, 2017 and 2016
(Expressed in Canadian Dollars)

	December 31, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents (note 5)	**$ -**	$ 85,650
Trade and other receivables (note 7)	**1,487,373**	550,696
Investment tax credits recoverable (note 6)	**350,257**	-
Inventory (note 8)	**1,530,508**	1,116,429
Prepayments	**90,283**	19,123
	3,458,421	1,771,898
Note Receivable (note 10)	**154,183**	-
Derivative asset (note 10 (b))	**9,491**	-
Investments (note 10)	**30,530**	157,320
Property and equipment (note 12)	**1,605,523**	259,360
TOTAL ASSETS	**$ 5,258,148**	$ 2,188,578
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Bank indebtedness (note 13)	**$ 326,448**	$ 150,000
Trade and other payables	**3,905,022**	1,266,353
Deferred revenue	**491,266**	-
	4,722,736	1,416,353
Shareholders' equity:		
Share capital (note 14)	**6,008,347**	4,086,270
Contributed surplus	**2,157,803**	1,647,963
Accumulated other comprehensive loss	**(271,501)**	-
Deficit	**(7,359,237)**	(4,962,008)
	535,412	772,225
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIENCY)	**$ 5,258,148**	$ 2,188,578

Going concern (note 2)
Commitments (note 20)
Subsequent events (note 22)

On Behalf of the Board:

"Karl Kenny" Director ***"Shaun McEwan"*** Director

The accompanying notes form part of the consolidated financial statements.

KRAKEN

Consolidated Statements of Net Loss and Comprehensive Loss
For the Years Ended December 31, 2017 and 2016
(Expressed in Canadian Dollars)

	2017	**2016**
Product Revenue	**$ 2,874,467**	$ 2,245,318
Service Revenue	**659,138**	22,500
	3,533,605	2,267,818
Cost of sales (note 8)	**1,936,463**	1,017,992
	1,597,142	1,249,826
Administrative expenses	**2,722,486**	1,671,909
Research and development costs	**1,955,886**	837,805
Share-based compensation (note 14 (d))	**275,600**	143,500
Investment tax credits recoverable	**(350,257)**	-
	4,603,715	2,653,214
Loss from operating activities	**(3,006,573)**	(1,403,388)
Foreign exchange loss	**66,593**	5,599
Loss on settlement of liability (note 14(f))	**-**	5,700
Financing costs – line of credit	**31,625**	5,488
Gain on sale of Investment (note 10 (a))	**(707,562)**	-
Net loss	**$ (2,397,229)**	$ (1,420,175)
Basic and diluted loss income per share	**$ (0.03)**	$ (0.02)
Basic and diluted weighted average number of shares outstanding	**87,462,605**	73,948,690

The accompanying notes form part of the consolidated financial statements.

KRAKEN

Consolidated Statements of Net Loss and Comprehensive Loss
For the Years Ended December 31, 2017 and 2016
(Expressed in Canadian Dollars)

	2017	2016
Net loss	**$(2,397,229)**	**$(1,420,175)**
Other comprehensive loss		
Items that may be reclassified to profit or loss		
Currency translation adjustment	**(271,501)**	**-**
Other comprehensive loss	**(271,501)**	**-**
Comprehensive loss	**$(2,668,730)**	**$(1,420,175)**

The accompanying notes form part of the consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity (Deficiency)
For the Years Ended December 31, 2017 and 2016
(Expressed in Canadian Dollars)

2017	Number of Shares	Share capital (note 14)	Contributed Surplus	Accumulated Other Comprehensive Loss	Deficit	Total
Balance at January 1, 2017	78,519,414	$ 4,086,270	$ 1,647,963	$ -	$ (4,962,008)	$ 772,225
Net loss	-	-	-	-	(2,397,229)	(2,397,229)
Transactions with shareholders, recorded directly in equity:						
Issue of common shares on private placement (note14(a))	11,806,660	1,840,299	284,900	-	-	2,125,199
Issue of common shares on warrant exercises	666,666	150,660	(50,660)	-	-	100,000
Advance share subscriptions		17,000				17,000
Share issue costs (note 14(a))	-	(85,882)	-	-	-	(85,882)
Share-based compensation	-	-	275,600	-	-	275,600
Other comprehensive loss (gain)	-	-	-	(271,501)		(271,501)
Shareholders' equity (deficiency) as at December 31, 2017	90,992,740	$ 6,008,347	$ 2,157,803	$ (271,501)	$ (7,359,237)	$ 535,412

2016	Number of Shares	Share capital (note 10)	Contributed Surplus	Cumulative Translation Adjustment	Deficit	Total
Balance at January 1, 2016	71,068,214	$ 3,072,426	$ 1,437,710	$ -	$ (3,541,833)	$ 968,303
Net loss	-	-	-	-	(1,420,175)	(1,420,175)
Transactions with shareholders, recorded directly in equity:						
Issue of common shares on private placement (note14(a))	7,159,534	944,630	129,300	-	-	1,073,930
Issue of common shares on warrant exercises	58,333	13,869	(5,119)	-	-	8,750
Issue of common shares on debt settlement (note 14(f))	233,333	35,000	5,700	-	-	40,700
Expiry of share purchase warrants, net of income taxes (note 19)	-	63,128	(63,128)	-	-	-
Share issue costs (note 14(a))	-	(42,783)	-	-	-	(42,783)
Share-based compensation	-	-	143,500	-	-	143,500
Shareholders' equity (deficiency) as at December 31, 2016	78,519,414	$ 4,086,270	$ 1,647,963	$ -	$ (4,962,008)	$ 772,225

The accompanying notes form part of the consolidated financial statements.

	2017	2016
Cash flows used in operating activities		
Net loss	**$ (2,397,229)**	$ (1,420,175)
Adjustments for items not involving cash:		
Depreciation	**94,030**	57,534
Share-based payments	**275,600**	143,500
Loss on settlement of liability (note 14(f))	**-**	5,700
Non-cash finance costs	**1,898**	-
Unrealized foreign exchange gain	**(19,141)**	-
Investment tax credits receivable	**(350,257)**	-
Gain on sale of investment	**(707,562)**	-
Changes in non-cash working capital (note 19)	**1,064,573**	(417,792)
Net cash flows used in operating activities	**(2,038,088)**	(1,631,233)
Cash flows from (used in) investing activities		
Proceeds on disposal of investment	**864,882**	(157,410)
Investment, note receivable and derivative asset (note x)	**(176,961)**	-
Purchase of property, plant and equipment	**(1,069,868)**	(131,951)
	(381,947)	(289,361)
Cash flows from (used in) financing activities		
Proceeds from private placement	**2,125,199**	1,073,930
Proceeds from exercise of warrants	**100,000**	8,750
Advance share subscriptions received	**17,000**	-
Share issue costs	**(85,882)**	(42,783)
Increase in bank indebtedness	**176,448**	-
Increase (decrease) in loans to (from) a director	**-**	194,317
	2,332,765	1,234,214
Net increase (decrease) in cash	**(87,270)**	(686,380)
Effect of foreign exchange on cash	**1,620**	90
Cash at beginning of year	**85,650**	771,940
Cash at end of year	**$ -**	$ 85,650

1. Corporate Information:

Kraken Robotics Inc. ("Kraken" or the "Company") was incorporated on May 14, 2008 under the *Business Corporations Act, British Columbia*), is a publicly traded company, and has its registered office located at 100 King Street. West, #1600, Toronto, Ontario, M5X 1G5.

The Company was incorporated as Anergy Capital Inc. ("Anergy") under the Business Corporations Act, British Columbia and was classified as a Capital Pool Company ("CPC") as defined under Policy 2.4 of the TSX Venture Exchange. The principal business of the Company at that time was the identification of an asset or business acquisition that would meet the requirements as a Qualifying Transaction ("QT") as defined in Policy 2.4.

On February 18, 2015, the Company closed its Qualifying Transaction pursuant to an agreement between Anergy and Kraken Robotic Systems Inc., and Anergy changed its name to Kraken Robotics Inc. (together, "the Company").

The Company's principal business is the design, manufacture and sale of software-centric sensors and underwater robotic systems.

2. Going concern:

These consolidated financial statements have been prepared on a going concern basis, which assumes the Company will continue in operation for the foreseeable future and be able to realize its assets and discharge its liabilities and commitments in the normal course of business. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. Management is aware, in making its assessment, of material uncertainties related to events or conditions that cast significant doubt upon the Company's ability to continue as a going concern, as the Company experienced significant losses and negative cash flows from operations since inception and at December 31, 2017 has a working capital deficit of $1,264,315 and a deficit of $7,359,237 (December 31, 2016 - $4,962,008).

The ability of the Company to continue as a going concern and to realize its assets and discharge its liabilities when due is dependent on its ability to achieve and maintain profitable operations and positive cash flows from operations in the future and/or upon securing additional financing. The timing and availability of additional financing will be determined largely by the performance of the Company and market conditions and there is no certainty that the Company will be able to raise funds as they are required in the future.

These consolidated financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis was not appropriate, then adjustments would be necessary in the carrying amount of assets and liabilities, the reported revenues and expenses, and the statement of financial position classifications used.

3. Basis of presentation:

(a) Statement of compliance:

These consolidated financial statements, including comparatives, have been prepared in accordance with International Financial Reporting Standards ("IFRS") and Interpretations by the International Financial Reporting Interpretations Committee ("IFRIC").

These consolidated financial statements were approved by the Board of Directors on April 30, 2018.

(b) Basis of measurement and reclassification of comparative figures:

These consolidated financial statements have been prepared on a historical cost basis.

3. Basis of presentation (continued):

The consolidated financial statements are presented in Canadian dollars, which is the Company's functional and presentation currency.

Due to increased growth in revenue and employee base, detailed time tracking has been implemented for improved accounting to Costs of Sales, Research and Development, and Administrative expenses. As a result, comparative figures for Wages and Benefits that were previously presented as Employee Costs have been reclassified for presentation purposes. In addition, Government Assistance that was previously reported separately has been reclassified as a reduction to these amounts and allocated by department accordingly (refer to note 16).

(c) Accounting estimates and judgments:

The preparation of consolidated financial statements in accordance with IFRS requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and may have an impact on future periods. The more significant areas requiring the use of management estimates and judgments are discussed below:

i) Estimates of useful lives of property and equipment

Useful lives and residual value of property and equipment are reviewed by management on a regular basis to ensure assumptions are still valid. Property and equipment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be fully recoverable. If an asset's recoverable amount is less than the asset's carrying amount, an impairment loss is recognized.

Any changes in estimates would impact the economic useful lives and the residual values of the assets and, therefore, future depreciation charges could be revised.

ii) Recovery of deferred tax assets

Deferred tax assets, including those arising from tax loss carry-forwards, capital losses and temporary differences are recognized only where it is considered probable that they will be recovered, which is dependent on the generation of sufficient future taxable profits. Assumptions about the generation of future taxable profits depend on management's estimates of future cash flows.

Judgments are also required about the application of income tax legislation. These judgments and assumptions are subject to risk and uncertainty, hence there is a possibility that changes in circumstances will alter expectations, which may impact the amount of deferred tax assets and deferred tax liabilities recognized on the statement of financial position and the amount of other tax losses and temporary differences not yet recognized. In such circumstances, some or all of the carrying amounts of recognized deferred tax assets and liabilities may require adjustment, resulting in a corresponding credit or charge to the statement of net income (loss) and comprehensive income (loss).

iii) Share-based payments

The amounts recorded for share-based compensation are based on estimates. The Black Scholes model is used to estimate the fair value of stock options at the date of grant based on estimates of assumptions for share price, expected volatility, expected number of options to vest, dividend yield, risk-free interest rate, expected forfeitures and expected life of the options. Changes in these assumptions may result in a material change to the amounts recorded for the issuance of stock options.

3. Basis of presentation (continued):

iv) Revenue

Revenues from certain fixed price sales contracts are recognized using the percentage of completion method. These revenues are recognized proportionally with the degree of completion of work. The Company uses the efforts-expended method to calculate the degree of completion of work based on the labour and material costs incurred as at the balance date compared to the estimated total labour and material costs. Work in progress is valued by taking into consideration the labour and material costs incurred but not yet invoiced and received receipts.

(d) Derivative financial instruments

The Company records the fair value of derivative assets using valuation models where the fair value cannot be determined in active markets. The inputs used in the fair value models contain inherent uncertainties, estimates and use of judgment as certain valuation inputs are unobservable.

4. Significant accounting policies:

(a) Consolidation:

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Kraken Robotic Systems Inc. and Kraken Robotics GmbH, which was active in 2017 and inactive in 2016. Kraken Robotic Systems Inc. is a Canadian corporation engaged in the design and manufacture of underwater sensor, software, and underwater vehicles. The company's functional currency is the Canadian dollar. Kraken Robotics GmbH is a German corporation engaged in the design of underwater sensors and software. The company began operations in Bremen, Germany in 2017 and has the Euro as a functional currency.

(i) Subsidiaries

Subsidiaries are entities controlled by the Company. The Company controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The financial statements of subsidiaries are included in the consolidated financial statements from the date on which control commences until the date on which control ceases.

The financial statements of the subsidiary are prepared for the same reporting period as the parent company. When necessary, adjustments are made to the financial statements of the subsidiary to bring their accounting policies in line with those used by the parent company.

Subsidiaries are fully consolidated from the date on which control is transferred to the Company and cease to be consolidated from the date on which control is transferred out of the Company. A change in the ownership interest of a subsidiary that does not result in a loss of control is accounted for as an equity transaction.

(ii) Transactions eliminated on consolidation

Inter-company balances and transactions, and any unrealized income and expenses arising from inter-company transactions, are eliminated in preparing the consolidated financial statements.

4. Significant accounting policies (continued):

(b) Revenue recognition:

(i) Product Revenue:

Revenue from the sale of goods is recognized when the significant risks and rewards of ownership have transferred to the customer, recovery of the consideration is probable, the associated costs and possible return of goods can be estimated reliably, there is no continuing management involvement with the goods, and the amount of revenue can be estimated reliably. In cases where products are designed and manufactured over several quarterly periods, the Company recognizes revenue from rendering of services in proportion to the stage of completion of the transaction at the reporting date. The stage of completion is assessed based on surveys of work performed.

(ii) Service Revenue:

The Company recognizes revenue from rendering of services in proportion to the stage of completion of the transaction at the reporting date. The stage of completion is assessed based on surveys of work performed.

(c) Government grants:

Government grants are initially recognized as deferred income at fair value if there is reasonable assurance that they will be received and the Company will comply with the conditions associated with the grant; they are netted against the cost of the associated assets.

Grants that compensate the Company for expenses incurred are recognized in profit or loss, by way of a reduction of the corresponding expenses, on a systematic basis in the periods in which the expenses are recognized.

(d) Foreign currency transactions:

In preparing the financial statements of each individual corporate entity, transactions in foreign currencies other than the Company's functional currency (foreign currencies) are recognized at the rates of exchange prevailing at the dates of the transactions. At the end of each reporting period, monetary items denominated in foreign currencies are retranslated at the rates prevailing at that date. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences on monetary items are generally recognized in profit or loss in the period in which they arise.

(e) Foreign currency transactions:

These consolidated financial statements are presented in Canadian dollars. The results and financial position of all the Company's entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- shareholders' equity is translated at historical rates of exchange;
- intercompany loans are translated at historical rates of exchange as they are considered part of the net investment in foreign subsidiaries and for which settlement is neither planned nor likely to occur in the foreseeable future;
- other assets and liabilities are translated at the closing rate at the date of the statement of financial position;
- income and expenses for each income statement presented are translated at monthly average exchange rates; and
- all resulting exchange differences are recognized within Accumulated Other Comprehensive Income ("AOCI") which is a separate component of equity.

4. Significant accounting policies (continued):

(f) Income tax:

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognized in profit or loss except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the reporting date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized. Deferred tax is not recognized for the following temporary differences: the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss, and differences relating to investments in subsidiaries and jointly controlled entities to the extent that it is probable that they will not reverse in the foreseeable future. In addition, deferred tax is not recognized for taxable temporary differences arising on the initial recognition of goodwill.

(g) Inventories:

Inventories are recorded at the lower of cost and net realizable value. Cost is determined on a first-in, first-out basis.

(h) Property and equipment:

All items of property and equipment are measured at historical cost less accumulated depreciation and accumulated impairment losses.

Cost includes expenditures that are directly attributable to the acquisition of the asset. Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be measured reliably. The carrying amount of the replaced part is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in profit or loss as incurred.

Depreciation is calculated using estimation to allocate their cost, net of estimated residual values, over their estimated useful lives using the following methods and at the following annual rates:

Asset	Basis	Rate
Computer equipment	Declining balance	50%
Leasehold improvements	Straight-line	20%
Autonomous underwater vehicle	Straight-line	12.5%
Computer software	Straight-line	20%
Furniture and fixtures	Declining balance	20%
Tools and equipment	Straight-line	10%

Depreciation methods, useful lives and residual values are reviewed at each financial year end and adjusted prospectively, if appropriate.

4. Significant accounting policies (continued):

(i) Research and development:

Research costs are expensed as incurred. Development costs are capitalized only if the expenditure can be measured reliably, the product or process is technically and commercially feasible, future economic benefits are probable and the Company intends to and has sufficient resources to complete development and to use or sell the asset. Otherwise, such costs are expensed as incurred. Subsequent to initial recognition, development costs are measured at cost less accumulated amortization and any accumulated impairment losses. To date, no development costs have been capitalized.

(j) Financial instruments

(i) Financial assets

The Company initially recognizes loans and receivables on the date that they originate. All other financial assets are recognized initially on trade date at which the Company becomes party to the contractual provision of the instrument.

The Company derecognizes a financial asset when the contractual rights to the cash flows from the asset expire, or the rights to receive the contractual cash flows on the financial asset are transferred.

The Company has the following non-derivative financial assets: loans and receivables and investments.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition loans and receivables are measured at amortized cost using the effective interest method, less any impairment losses.

Loans and receivables comprise cash, trade and other receivables and note receivable.

Cash comprises cash on hand and balances on deposit with Tier 1 Canadian chartered banks.

Investments

The investments in equity instruments are recorded at fair value.

Embedded derivatives

Embedded derivatives are contained in non-derivative host contracts and are treated as separate derivatives when they meet the definition of a derivative, and their risks and characteristics are not closely related to those of the host contracts. Embedded derivatives are recorded at fair market value with mark-to-market adjustments recorded in profit or loss.

Fair Value:

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy establishes three levels to classify the inputs to valuation techniques used to measure fair value.

Level 1: Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.

4. Significant accounting policies (continued):

(j) Financial instruments (continued)

(i) Financial assets (continued)

Level 2: Inputs are quoted prices in markets that are not active, quoted prices for similar assets or liabilities in active markets, inputs other than quoted prices that are observable for the asset or liability (for example, interest rate and yield curves observable at commonly quoted intervals, forward pricing curves used to value currency and commodity contracts, volatility measurements used to value option contracts and observable credit default swap spreads to adjust for credit risk where appropriate), or inputs that are derived principally from or corroborated by observable market data or other means.

Level 3: Inputs are unobservable (supported by little or no market activity).

The fair value hierarchy gives the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs.

(ii) Financial liabilities

The Company initially recognizes other financial liabilities on the trade date at which the Company becomes party to the contractual provisions of the instrument. Such financial liabilities are recognized initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortized cost using the effective interest method.

The Company derecognizes financial liabilities when its contractual obligations are discharged or cancelled or expire.

The Company has the following non-derivative other financial liabilities: trade and other payables, and bank indebtedness.

(iii) Share capital

Common shares are classified as equity. Incremental costs directly attributable to the issue of common shares and share options are recognized as a deduction from equity, net of any tax effects. From time to time the Company issues warrants in conjunction with share capital. Proceeds are allocated between share capital and warrants based on the relative fair value of each instrument. The fair value of the warrants is estimated using an appropriate option pricing model, as outlined in note 14.

(k) Impairment:

(i) Financial assets (including receivables)

Financial assets, other than those recorded at fair value through profit or loss, are assessed for objective evidence of impairment at the end of each reporting period. Financial assets are considered to be impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows have been affected.

For financial assets carried at amortized cost, the amount of the impairment loss recognized is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate. Losses are recognized in profit or loss and reflected in an allowance account against accounts receivable. When a subsequent event causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

4. Significant accounting policies (continued):

(k) Impairment: (continued)

(ii) Non-Financial assets

The carrying amounts of the Company's non-financial assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indications exist, the asset's recoverable amount is estimated.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For the purpose of impairment testing, assets are grouped together into the smallest group of assets which generates cash inflows from continuing use that is largely independent of the cash inflows of other assets or groups of assets (the "cash-generating-unit" or "CGU").

(l) Earnings (loss) per share:

The Company presents basic and diluted earnings (loss) per share for its common shares. Basic earnings (loss) per share is calculated by dividing the profit or loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is determined by adjusting the profit or loss attributable to common shareholders and the weighted average number of shares outstanding adjusted for the effects of all dilutive potential common shares.

(m) Application of new or revised IFRS and interpretations:

The following standards and amendments to existing standards have been adopted by the Company effective January 1, 2017:

Amendments to IAS 7, Statement of Cash Flows:

In January 2016, the IAS issued amendments to IAS 7, Statement of Cash Flows. The amendments require disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flow and non-cash changes. One way to meet this new disclosure requirement is to provide a reconciliation between the opening and closing balances for liabilities from financing activities. These amendments became effective for annual periods beginning on or after January 1, 2017 and the Company adopted these changes with no impact on the 2017 annual consolidated financial statements.

Amendments to IAS 12, Income Taxes:

In January 2016, the IASB issued amendments to IAS 12, Income Taxes. The amendments clarify that the existence of a deductible temporary difference depends solely on a comparison of the carrying amount of an asset and its tax base at the end of the reporting period, and is not affected by possible future changes in the carrying amount or expected manner of recovery of the asset. The amendments also clarify the methodology to determine the future taxable profits used for assessing the utilization of deductible temporary differences. The amendments became effective for annual periods beginning on or after January 1, 2017 and adoption of the amendments did not have a material impact on the consolidated financial statements.

(n) Future changes in accounting policies:

A number of new standards, and amendments to standards and interpretations under IFRS, are not yet effective for the year ended December 31, 2017, and have not been applied in preparing these consolidated financial statements.

4. Significant accounting policies (continued):

(n) Future changes in accounting policies: (continued)

IFRIC 23, Uncertainty over Income Tax Treatments:

The Interpretation provides guidance on the accounting for current and deferred tax labilities and assets in circumstances in which there is uncertainty over income tax treatments. It requires an entity to contemplate whether uncertain tax treatments should be considered separately, or together as a group, based on which approach provides better predictions of the resolution. Probability will be determined whether the tax authorities will accept the uncertain tax treatment, and if it is not probable that the uncertain tax treatment will be accepted, they will measure the tax uncertainty based on the most likely amount or expected value, depending on whichever method better predicts the resolution of the uncertainty. The Company intends to adopt the Interpretation in its financial statements for the annual period beginning on January 1, 2019. The Company does not expect the Interpretation to have a material impact on the consolidated financial statements.

IFRS 15, Revenue from Contracts with Customers:

The standard contains a single model that applies to contracts with customers and two approaches to recognizing revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognized. New estimated and judgmental thresholds have been introduced, which may affect the amount and/or timing of revenue recognized. The Company intends to adopt IFRS 15 in its consolidated financial statements for the annual period beginning on January 1, 2018. While the extent of the impact of adoption of the standard has not yet been determined, the Company does not expect to be able to apply percentage of completion method for revenue recognition on product sales going forward. As such, quarterly revenue results could be more variable as certain product orders often take more than one quarter from order to shipment.

With adoption of IFRS 15 in 2018, the Company does not expect to recognize product revenue using percentage of completion method. This will result in quarterly product revenues being more variable as orders which are not fulfilled within a quarter, will be recognized as revenue upon delivery to the customer. If the Company does not have inventory on hand to fulfill an order, it could take one to three quarters to deliver the product to the customer and recognize revenue. The time will vary based on supplier lead times, whether the order is for a custom or established product, and the build and test times for the product.

IFRS 9, Financial Instruments:

IFRS 9, Financial Instruments, will replace IAS 39, Financial Instruments: Recognition and Measurement, and some of the requirements of IFRS 7, Financial Instruments: Disclosures. The Objective of IFRS 9 is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows. The IASB has determined the revised effective date for IFRS 9 will be for annual periods beginning on or after January 1, 2018. The Company has not completed the assessment of this impact of the change to the consolidated financial statements based on the characteristics of financial instruments outstanding at the time of adoption.

IFRS 16, Leases:

In January 2016, the IASB issued IFRS 16 *Leases*. This standard introduces a single lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognize a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. This standard substantially carries forward the lessor accounting requirements of IAS 17, while requiring enhanced disclosures to be provided by lessors. Other areas of the lease accounting model have been impacted, including the definition of a lease. Transitional provisions have been provided. The new standard is effective for annual periods beginning on or after January 1, 2019. The extent of the impact of adoption of the standard has not yet been determined.

4. Significant accounting policies (continued):

(n) Future changes in accounting policies: (continued)

Amendments to IFRS 2, Share-based Payments:

In June 2016, the IASB issued amendment to IFRS 2, Shares-based Payments, clarifying how to account for certain types of share-based payment transactions. The amendments provide requirements on the accounting for a) the effects of vesting and non-vesting conditions on the measurement of cash-settled share-based payments; b) share-based payment transactions with a net settlement feature for withholding tax obligations; and c) a modification to the terms and conditions of a share-based payment that changes the classification of the transaction from cash-settled to equity-settled. The amendments apply for annual periods beginning on or after January 1, 2018. As a practical simplification, the amendments can be applied prospectively. The Company intends to adopt the amendments to IFRS 2 in its financial statements for the annual period beginning on January 1, 2018. The extent of the impact of adoption of the standard has not yet been determined.

5. Cash and cash equivalents

Cash and cash equivalents consists of the following:

	2017	2016
Cash	$ -	$ 85,650
Bank Indebtedness	(326,448)	-
	$ (326,448)	$ 85,650

6. Investment tax credit receivable

At December 31, 2017, the Company had filed Scientific Research and Experimental Development (SR&ED) Expenditures Claim with the Canada Revenue Agency for the fiscal years ended December 31, 2016 and December 31, 2015, which result in refundable Provincial Investment Tax Credits of approximately $254,083 and $96,174, respectively (December 31, 2016 - $Nil).

7. Trade and other receivables:

Trade and other receivables consist of the following:

	2017	2016	2015
Trade receivables	$ 279,707	$ 248,386	$ 387,825
Unbilled accounts receivable	775,251	153,729	132,520
Government assistance receivable and other	432,415	148,581	32,089
	$ 1,487,373	$ 550,696	$ 376,571

8. Inventory

As at December 31, 2017, the Company held $1,530,508 (2016 - $1,116,429) in inventory, consisting of $687,133 (2016 - $1,116,429) in raw materials and $843,375 (2016 - $Nil) in work-in-progress. Included in cost of sales is inventory of $1,274,744 (2015 - $510,687).

9. Prepayments

As at December 31, 2017, the Company had made prepayments of $90,283 (2016 - $19,123) towards inventory, which included an amount of $62,763 paid to one vendor.

10. Investments

(a) During 2016, the Company had entered into an agreement with Square Robot, Inc., a private US-based company, in respect of the co-design of small robots for large above ground storage tanks. Pursuant to the agreement, as at December 31, 2016, the Company had invested CAD$157,320 (US$120,000) in the company.

During the first quarter of Fiscal 2017, the Company disposed of its investment in Square Robot Inc., a non-core asset, for consideration of US$700,000, half of which was received on February 28, 2017, with the balance in the form of a note receivable due no later than June 27, 2017. Subsequently, the Company reduced the amount owing from $458,835 (US$350,000) to $393,287 (US$300,000) in exchange for early settlement of the note receivable which occurred on May 15, 2017. The net result of this activity was a gain on sale of investment of $707,562.

(b) During the second quarter of Fiscal 2017, the Company acquired a minority interest in ENITECH Subsea GmbH of Rostock, Germany, which has been renamed Kraken Power GmbH. Under the agreement, Kraken acquired a 19.9% equity interest in the Company and provided a €110,000 (CAD $165,572) convertible loan. The loan bears interest at 5% accrued per annum, and has a term of three years. Through the conversion of the loan to equity and a further investment capped at €200,000, the Company may acquire a further 55.1% equity interest, for an aggregate 75% ownership stake position, in Kraken Power GmbH.

The Company does not have any power or significant influence over Kraken Power GmbH, so the investment is classified as available for sale and has been recorded at fair market value. The note receivable is recorded at amortized cost, which was €110,000 (CAD $154,183) at December 31, 2017. The conversion option is a derivative financial asset that is recorded at fair value, with changes in fair value recognized through profit or loss. The premium paid for the derivative at inception of $11,389 represents the initial fair value, which was determined using an option pricing model. The fair value has been estimated based on amortizing the premium on a straight-line basis over the term of the option agreement.

As at December 31, 2017 and December 31, 2016, the Company's investments were:

	December 31, 2017		December 31, 2016	
	EUR	**CAD**	**USD**	**CAD**
Square Robot, Inc.	€ -	$ -	$ 120,000	$ 157,320
Kraken Power GmbH	€ 20,520	$ 30,530	$ -	$ -

11. Financial instruments:

Credit Risk:

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was:

	December 31, 2017	December 31, 2016
Cash (bank indebtedness)	$ (326,448)	$ 85,650
Trade and other receivables	1,487,373	550,696
Note receivable	154,183	-
Derivative asset	9,491	-
Share subscription receivable	76,833	76,833
	$ 1,401,432	$ 713,179

The Company manages credit risk by holding the majority of its cash with high quality financial institutions in Canada, where management believes the risk of loss to be low.

11. Financial instruments: (continued)

Credit Risk: (continued)

Revenues from the top 3 customers represented 69% of the Company's revenue in the year ended December 31, 2017 (2016 – top 3 customers represented 85%). At December 31, 2017, 90% of the trade receivables balance were owing from 2 customers (2016 – 66% of the trade receivables was owing from 1 customer). At December 31, 2017, the Company had recorded deferred revenues of $491,266 (2016 – $Nil)

The share subscription receivables relate to the exercise price for options issued to employees and subsequently exercised. It is recorded as a reduction of share capital.

Liquidity Risk:

Liquidity risk is the risk that the Company will encounter difficulty in meeting the obligations associated with its financial liabilities that are settled by delivering cash or another financial asset. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions. As of December 31, 2017, the Company had a cash and cash equivalents balance of $Nil (December 31, 2016 - $85,650) to settle current liabilities of $4,722,736 (December 31, 2016 - $1,416,353). Refer to note 2 for discussion of going concern risk.

Market Risk:

Market risk is the risk of loss that may arise from changes in market factors such as interest rates, foreign exchange rates, and commodity and equity prices.

(a) Interest rate risk

At December 31, 2017, the Company has cash balances of $Nil and has drawn $326,448 against its line of credit. The Company is exposed to interest rate risk on its line of credit balance.

(b) Foreign currency risk

The Company's exposure to foreign currency risk is limited to sales in USD, EUR, and GBP, certain purchases of inventory in USD, EUR and GBP, and its note receivable. The Company does not use any form of hedging against fluctuations in foreign exchange.

The Company's exposure to foreign currency risk was as follows:

	December 31, 2017	December 31, 2016
Financial liabilities denominated in foreign currency:		
Trade and other payables USD	$ 452,534	$ 87,295
Trade and other payables GBP	202,342	65,196
Trade and other payables EUR	544,026	1,247
Financial assets denominated in a foreign currency:		
Trade and other receivables USD	151,184	378,856
Trade and other receivables GBP	-	-
Trade and other receivables EUR	587,886	-

For the year ended December 31, 2017, with other variables remaining constant, a 10% increase (decrease) in the exchange rate of the US dollar, British Pound and Euro to the Canadian dollar exchange rate would have increased (decreased) the Company's net loss by approximately $280,342 (2016 - $74,000).

11. Financial instruments (continued):

Fair Value:

During the year ended December 31, 2017, there were no transfers between level 1, level 2 and level 3 classified assets and liabilities. The fair values of the Company's financial instruments are considered to approximate the carrying amounts. The following table provides the disclosures of the fair value and the level in the hierarchy:

December 31, 2017	Level 1	Level 2	Level 3
Financial assets classified as loans and receivables:			
Trade and other receivables	$ -	$ 1,487,373	$ -
Investment tax credits recoverable	-	350,257	-
Note receivable	-	154,183	-
Derivative asset	-	-	9,491
Investment	-	-	30,530
Share subscription receivables	-	76,833	-
Financial liabilities at amortized cost:			
Bank indebtedness	-	326,448	-
Trade and other payables	-	3,905,022	-

December 31, 2016	Level 1	Level 2	Level 3
Financial assets classified as loans and receivables:			
Cash	$ 85,650	$ -	$ -
Trade and other receivables	-	550,696	-
Share subscription receivables	-	76,833	-
Financial liabilities at amortized cost:			
Bank indebtedness	-	150,000	-
Trade and other payables	-	1,266,353	-

12. Property and equipment:

(a) As at December 31, 2017 and 2016, there were no assets pledged as security.

(b) Reconciliation of property and equipment:

	Furniture and Equipment	Computer equipment	Computer software	Leasehold improvements	AUV Vehicle	Total
Cost						
Balance at January 1, 2016	**$ 61,096**	**$ 23,504**	**$ 64,027**	**$ 93,996**	**$ -**	**$ 242,623**
Additions	31,085	32,855	57,119	10,892	-	131,951
Balance at December 31, 2016	**$ 92,181**	**$ 56,359**	**$ 121,146**	**$ 104,888**	**$ -**	**374,574**
Additions (adjustments)	26,590	34,785	(121,146)	10,789	1,489,175	1,440,193
Balance at December 31, 2017	**$ 118,771**	**$ 91,144**	**$ -**	**$ 115,677**	**$ 1,489,175**	**$ 1,814,767**
Depreciation						
Balance at January 1, 2016	**$ 10,783**	**$ 8,530**	**$ 17,876**	**$ 20,491**	**$ -**	**$ 57,680**
Depreciation	8,964	11,958	20,084	16,528	-	57,534
Balance at December 31, 2016	**$ 19,747**	**$ 20,488**	**$ 37,960**	**$ 37,019**	**$ -**	**$ 115,214**
Depreciation (adjustments)	12,192	23,784	(37,960)	18,763	77,251	94,030
Balance at December 31, 2017	**$ 31,939**	**$ 44,272**	**$ 0**	**$ 55,782**	**$ 77,251**	**$ 209,244**

12. Property and equipment: (continued)

(b) Reconciliation of property and equipment: (continued)

Carrying amounts						
At December 31, 2016	**$ 72,434**	**$ 35,871**	**$ 83,186**	**$ 67,869**	**$ -**	**$ 259,360**
At December 31, 2017	**$ 86,832**	**$ 46,872**	**$ -**	**$ 59,895**	**$ 1,411,924**	**$ 1,605,523**

13. Bank indebtedness:

At December 31, 2017, the Company had a $350,000 line of credit for general operating purposes (the “operating line”). The operating line bears interest at the bank’s prime rate plus 2%, payable monthly. As at December 31, 2017, a total of $326,448 (2016 - $150,000) was drawn against this facility.

14. Share capital:

Authorized: Unlimited number of common shares

On October 3, 2014, the Company completed a consolidation of its issued and outstanding common shares on 6.19:1 basis, reducing the issued and outstanding common shares to 40,416,667 from 250,000,000.

See the consolidated statements of changes in shareholders’ equity (deficiency) for a summary of changes in Share capital and Contributed surplus for the years ended December 31, 2017 and 2016.

(a) Private placements

On April 11, 2017, the Company closed a non-brokered private placement offering comprised of 11,806,660 units at a purchase price of $0.18 per Unit for aggregate proceeds of $2,125,199. Each Unit consisted of one common share and one-half of one common share purchase warrant (each whole common share purchase warrant, a “Warrant”), with each Warrant exercisable to acquire one common share of Kraken at $0.30 for a period of 24 months from the date of issuance. The Company paid a cash finder's fees of $12,600 and issued 191,333 finders warrants, and $73,282 legal and other costs, in connection with the offering. The gross proceeds of the financing are allocated between Share Capital and Contributed Surplus. The value of the warrants is determined using the Black Scholes pricing model and resulted in a $284,900 allocation to Contributed Surplus, with the remainder of $1,840,299 being allocated to Share Capital.

On August 15, 2016, the Company closed a non-brokered private placement offering comprised of 7,159,534 units (the “Units”) at a purchase price of $0.15 per Unit for aggregate proceeds of $1,073,930. Each Unit consisted of one common share and one-half of one common share purchase warrant (each whole common share purchase warrant, a "Warrant"), with each Warrant exercisable to acquire one common share of Kraken at $0.30 for a period of 24 months from the date of issuance. The Company paid share issue costs of $42,783, comprised of cash finder's fees of $18,375 and $24,408 legal and other costs, in connection with the offering.

(b) Share purchase warrants

On February 18, 2015, as part of the RTO (notes 1 & 5) the lenders of a $2,109,500 bridge loan to Kraken Robotic Systems Inc. converted the indebtedness into 14,063,326 common shares in the Company. On conversion of the bridge loan, the lenders also received share purchase warrants convertible into the same number of shares exercisable at a price of $0.15 per warrant for a period of thirty-six (36) months from the date of issuance.

14. Share capital (continued):

(b) Share purchase warrants (continued)

Two grants of warrants were issued pursuant to a private placement completed by Anergy in October 2014, prior to completion of the RTO:

i) Each full Warrant A warrant entitled the holder thereof to acquire one common share of the Company at a price of $0.15 after adjusting for the consolidation (or $0.0666666 prior to consolidation). During the year ended December 31, 2017, 666,666 (2016 – 58,333) warrants were exercised for proceeds of $100,000 (2016 - $8,750). The weighted average share price on the dates on which the warrants were exercised during the year was $0.15 (2016 - $0.20). On October 14, 2016, the remaining 275,000 warrants expired unexercised.

ii) Each full Warrant B warrant entitled the holder to acquire one common share at a price of $0.40 after adjusting for the consolidation (or $0.17777777 prior to consolidation). A total of 444,444 warrants expired unexercised on October 14, 2016.

A total of 3,579,767 share purchase warrants were issued in August 2016 upon closing the non-brokered private placement offering (see note 14(a) above).

A further 116,666 share purchase warrants were issued in August 2016 in respect of a debt settlement arrangement (see note 14(f) below).

In April 2017, the Company issued an additional 5,903,330 share purchase warrants in connection with the closing of a non-brokered private placement offering. (see note 14(a) above).

Share purchase warrant transactions are summarized for the years ending December 31, 2017 and 2016:

	Year ended December 31, 2017		Year ended December 31, 2016	
	Number of Warrants	Weighted Average Exercise Price	Number of Warrants	Weighted Average Exercise Price
Opening balance	17,759,759	$ 0.18	14,841,103	$ 0.16
Issued for private placement	5,903,330	0.30	3,579,767	0.30
Issued for debt settlement	-	-	116,666	0.30
Warrants exercised	(666,666)	0.15	(58,333)	0.15
Warrants expired	-	-	(719,444)	0.30
Ending balance	22,996,423	$ 0.21	17,759,759	$ 0.18
Warrants exercisable	22,996,423	$ 0.21	17,759,759	$ 0.18

At December 31, 2017 and December 31, 2016, the following share purchase warrants were outstanding:

Expiry Date	Exercise Price	December 31, 2017	December 31, 2016	Weighted Average Remaining Contractual Life
February 18, 2018	$0.15	13,396,660	14,063,326	0.13 years
August 12, 2018	$0.30	3,579,767	3,579,767	0.61 years
August 22, 2018	$0.30	116,666	116,666	0.89 years
April 11, 2019	$0.30	5,903,330	-	1.28 years
	$0.21	**22,996,423**	**17,759,759**	**0.67 years**

14. Share capital (continued):

(c) Share options

The Company has a share option plan, under which the Board of Directors is authorized to grant options to employees, directors, officers and consultants, enabling them to acquire up to 10% of the issued and outstanding share capital of the Company. The exercise price of each option is based on the market price of the Company's share as calculated on the date of grant. The options can be granted for a maximum term of five years. Options granted to investor relations consultants are subject to vesting provisions, as established by regulatory authorities, over a twelve month period, with no more than ¼ vesting during any three month period. Vesting provisions for other options are determined by the Company's Board of Directors.

During the year the Company issued 900,000 options to an investor relations consultant, and new employees and Directors. On December 15, 2017, upon Board of Directors approval, the Company issued 1,770,000 stock options to employees. The options have a three-year term, with vesting in three equal instalments consisting of the date of grant and one and two-year anniversaries of the initial grant. The exercise price on the options is $0.18.

The following options were outstanding as at December 31, 2017 and 2016:

	December 31, 2017		December 31, 2016	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Opening balance	4,960,000	$ 0.21	4,260,000	$ 0.23
Granted	2,670,000	0.18	900,000	0.15
Exercised	(100,000)	0.17	-	-
Expired	(400,000)	0.25	(200,000)	0.15
Ending balance	7,130,000	$ 0.19	4,960,000	$ 0.21
Options exercisable	4,204,167	$ 0.21	2,226,666	$ 0.22

All share options had exercise prices that were higher or equal to market prices at the date of grant.

Weighted Average Exercise Price	Expiry Date	Number Outstanding	Number Exercisable	Weighted Average Remaining Contractual Life
$ 0.25	March 17, 2018	1,310,000	1,310,000	0.21 years
0.20	May 13, 2018	250,000	250,000	0.36 years
0.21	July 1, 2018	100,000	100,000	0.50 years
0.15	October 12, 2019	600,000	200,000	1.78 years
0.15	December 1, 2019	300,000	200,000	1.92 years
0.17	March 8, 2020	150,000	87,500	2.19 years
0.21	June 1, 2020	2,000,000	1,250,000	2.42 years
0.17	September 8, 2020	350,000	116,667	2.69 years
0.18	October 4, 2020	300,000	100,000	2.76 years
0.18	December 15, 2020	1,770,000	590,000	2.96 years
$ 0.19		**7,130,000**	**4,204,167**	**1.98 years**

(d) Share-based compensation

During the year ended December 31, 2017, the Company recorded share-based compensation totaling $275,600 (2016 - $143,500), which was expensed in operations with a corresponding increase in contributed surplus.

The fair value of share options was estimated on the measurement date using the Black-Scholes option-pricing model and is amortized over the vesting period of the underlying options.

14. Share capital (continued):

(d) Share-based compensation (continued)

The fair values of the options granted were estimated using the Black-Scholes option pricing model with the following assumptions:

	Year ended December 31, 2017	Year ended December 31, 2016
Risk-free interest rate	0.59 to 0.67%	0.61 to 0.76%
Expected life of options	3 years	3 years
Expected volatility	189 to 211%	223 to 229%
Weighted average fair value per option	$0.11 to $0.16	$0.11 to $0.13
Dividend yield	Nil	Nil

(e) Debt settlement

On August 22, 2016 the Company settled debt of $35,000 by issuing 233,333 common shares and 116,666 share purchase warrants exercisable to acquire one common share of Kraken at $0.30 for a period of 24 months from the date of issuance. The share purchase warrants were valued at $5,700 and credited to contributed surplus. Fair value was determined using the Black-Scholes valuation model, based on a risk free interest rate of 0.57%, an expected life of two years, an expected volatility of 78.98% and a dividend yield rate of nil.

There was no debt settlement activity during fiscal 2017 for the Company.

15. Capital management:

The Company's objectives when managing its capital are to maintain a financial position suitable for supporting its operations and growth strategies, to provide an adequate return to shareholders and to meet its current obligations.

The Company's capital structure consists of shareholders' equity (deficiency). The Company makes adjustments to the capital structure depending on economic conditions, its financial position and performance. In order to maintain or adjust the capital structure, the Company may issue new shares, buyback shares or pay dividends, issue debt or sell assets to reduce debt.

16. Government assistance:

During the year ended December 31, 2017, the Company received government assistance in the amount of $1,566,940 and (2016 - $894,568). Government Assistance that was previously reported separately in the statement of net loss has been reclassified as a reduction to Cost of Sales, and Research & Development expense. The table below identifies the reclassification for the last 2 years.

	Government Assistance ($)	Cost of Sales ($)	Research & Development Costs ($)
2017	1,566,940	(529,861)	(1,037,079)
2016	894,568	(336,680)	(557,888)

17. Related party transactions:

(b) For the year ended December 31, 2017, the Company expensed $Nil in costs for a condominium unit that it rents from an individual related to a member of its management team (2016 - $9,500).

(c) Compensation of key management personnel:

	2017	2016
Share-based payments	$ 112,500	$ 98,900
Short-term employee benefits	12,701	11,644
Salaries and wages	459,308	403,750
	$ 584,509	$ 514,294

(d) Included in share subscription receivables at December 31, 2017 is 60,608 (December 31, 2016 - $60,608) owing from certain employees.

18. Income taxes:

The Company's provision for income taxes differs from the amount computed by applying the combined Canadian federal and provincial income tax rates to income (loss) before income taxes as a result of the following:

	For the year ended December 31, 2017	2016
Net loss	**$ (2,397,229)**	$ (1,420,175)
Statutory tax rates	**26.0%**	26.0%
Income taxes (recovery) computed at the statutory rates	**$ (623,280)**	$ (369,000)
Change in statutory rates and other	**(108,000)**	117,000
Permanent differences	**(17,000)**	46,000
Share issue costs	**(20,000)**	-
Adjustment to prior years provision versus statutory tax returns & expiry of non-capital losses	**-**	-
Change in unrecognized deductible temporary differences	**832,000**	206,000
Provision for income taxes	**$ -**	$ -

The tax effect of the following temporary differences and non-capital losses have not been recognized in the consolidated financial statements.

	2017	2016
Non-capital losses carried forward	**$ 1,178,000**	$ 761,000
Capital losses carried forward	**-**	1,000
Property, plant and equipment	**(30,000)**	(14,000)
Intangible assets	**140,000**	93,000
	$ 1,288,000	$ 841,000

The Company has approximately $3,958,000 of Canadian non-capital losses which may be applied to reduce taxable income in future years, and which if not utilized, will expire through to 2035. Future tax benefits which may arise as a result of future income tax assets have not been recognized in these consolidated financial statements as management believes that it is not probable that sufficient taxable income will be available to realize such assets.

19. Change in non-cash working capital:

	2017	2016
Increase in trade and other receivables	**$ (936,677)**	$ (174,125)
Increase in investment tax credit receivables	**(350,257)**	-
Increase in inventory	**(414,079)**	(609,387)
Increase in prepayments	**(71,160)**	(11,260)
Increase in trade and other payables	**2,169,032**	428,844
Increase (decrease) in deferred revenue	**491,266**	(201,864)
Increase in line of credit payable	**176,448**	150,000
	$ 1,064,573	$ (417,792)

20. Commitments:

The following is a summary of the minimum contractual obligations and commitments as at December 31, 2017:

	2018	2019	2020	2021	2022
Operating leases	$ 251,540	$ 167,640	$ 167,640	$ 167,640	$ 13,970
Research and Development	439,500	439,500	439,500	439,500	-

The Company currently has five lease agreements, as follows:

(i) an office lease in Nova Scotia at a rate of $1,039 per month including rent and operating costs that expires April 6, 2018;

(ii) a production facility lease in Newfoundland and Labrador at a rate of $5,833 per month rent only that expires on August 24, 2018;

(iii) an office lease at a rate of $13,790 per month including rent and estimated operating costs that expires on January 31, 2022;

(iv) an office lease in Germany at a rate of $499 euro per month rent only expiry March 31, 2018. New facility lease Apr 1, 2018 at 2,150 euro per month including rent and operating, six month commitment that expires month to month following the six month initial term; and

(v) portable modular trailer lease $570 per month rent only expires September 16, 2018.

The Company has entered into an agreement with Fraunhofer Institute of Optronic, System Technologies and Image Exploitation (“Fraunhofer IOSB”) of Germany whereby it has committed to grant research and development projects to Fraunhofer IOSB of a minimum EUR 300,000 over a period of five years, commencing in 2017. No such grants of research projects have been made to December 31, 2017.

21. Segmented information:

The Company operates in one reportable operating segment, being the design, manufacture and sale of underwater sonar and acoustic sensor equipment. The summarized financial information for revenue derived by geographic segment is as follows:

	2017	2016
Total revenues:		
Canada	**$ 919,324**	$ 22,500
United States	**86,757**	608,362
France	**424,463**	91,332
Italy	**108,145**	-
Israel	**271,139**	989,822
United Kingdom	**434,211**	-
Germany	**1,273,393**	-
Other	**16,175**	555,802
	$ 3,533,606	$ 2,267,818

22. Subsequent events:

Subsequent to December 31, 2017, the Company:

(a) entered into a non-revolving term loan facility backed by a customer contract that was not billed at year end for $750,000 from RBC, interest at prime plus 2.1% and is repayable in full by June 30, 2018.

(b) released from escrow the final 7,647,108 shares remaining as part of Kraken original RTO transaction.

(c) received proceeds of CDN $419,761 from 2,888,508 warrants exercisable into one common share at CDN$0.15 per share with an expiry of February 18, 2018. Of this amount, CDN $100,000 was received in 2017 through early exercise of warrants. The remaining 11,174,918 warrants were not exercised and have expired.

(d) completed a non-brokered private placement of 10,714,285 shares at a price of $0.14 raising gross proceeds of $1,500,000. The Company issued 9,000 finder’s shares connected with the placement.

(e) renewed its investor relations advisory agreement with a monthly cost of $7,000 and granted 450,000 incentive stock options to a consultant at an exercise price of $0.185 for a period of three years and will vest in equal quarterly installments over one-year.

(f) Issued 100,000 common shares priced at $0.17 per share in relation to advance stock options exercise proceeds recorded in December 2017, and recorded the expiry of 1,310,000 incentive stock options priced at $0.25.