

## **ZTEST Electronics Inc.**

Management's Discussion and Analysis

For The Year Ended June 30, 2011

(Prepared as at October 20, 2011)

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### **General**

The following Management Discussion and Analysis ("MD&A") has been prepared by the Company's management to accompany the consolidated financial statements of the Company as at June 30, 2011 and should only be read in conjunction with those financial statements. Additional information about the Company can be found at [www.sedar.com](http://www.sedar.com).

### **Forward-looking Information**

Certain statements in this MD&A may constitute "forward-looking" statements which involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company and its subsidiary, or the industry in which they operate, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. When used in this report, the words "estimate", "believe", "anticipate", "intend", "expect", "plan", "may", "should", "will", the negative thereof or other variations thereon or comparable terminology are intended to identify forward-looking statements. Such forward-looking statements reflect the current expectations of the management of the Company with respect to future events based on currently available information and are subject to risks and uncertainties that could cause actual results, performance or achievements to differ materially from those expressed or implied by those forward-looking statements, such as reduced funding, long sales cycles, currency and interest rate fluctuations, increased competition and general economic and market factors and including the risk factors summarized below under the heading "Risk Factors". New risk factors may arise from time to time and it is not possible for management of the Company to predict all of those risk factors or the extent to which any factor or combination of factors may cause actual results, performance or achievements of the Company to be materially different from those expressed or implied in such forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. Although the forward-looking statements contained in this MD&A are based upon what management believes to be reasonable assumptions, the Company cannot assure investors that actual results will be consistent with these forward-looking statements. The forward-looking statements contained in this MD&A speak only as of the date hereof. The Company does not undertake or assume any obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, except as required by law.

### **The Company**

The Company operates a single business segment involving the design, development, and assembly of printed circuit boards. The management of the Company, which has not changed since the preceding fiscal year end, is comprised of the following individuals:

<b><u>Name</u></b>	<b><u>Position(s)</u></b>
Wojciech Drzazga	Director and CEO
John Perreault <sup>(1)</sup>	Director and President
K. Michael Guerreiro <sup>(1) (2)</sup>	Director
Mike Hiscott <sup>(1) (2)</sup>	Director
Michael D. Kindy	VP Finance & CFO
William R. Johnstone	Secretary

<sup>(1)</sup> Denotes member of audit committee

<sup>(2)</sup> Denotes member of compensation committee

### **Corporate Performance**

The 2011 fiscal year provided very mixed results for the Company. Sales rose to more than \$4,000,000 for the second time in four years however the Company also incurred a loss for the year. The Company generated positive cash flow from operations and improved its cash position but also experienced an increase in its working capital deficiency. The Company reduced its long term debt, total liabilities and deficiency in assets but it also experienced a decline in capital under management. It would seem that the existence of these apparent contradictions makes it difficult to portray 2011 as being a successful year.

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### **Corporate Performance - continued**

Growth in product sales is certainly a positive result. The fact that this growth occurred during a period with some less than favourable economic conditions makes this an even more favourable result. Throughout 2011 the Company experienced market shortages of electronic components and significant increases in lead times when components were available. These market factors led directly to numerous issues related to scheduling production, in hampered ability to produce optimal product quantities in a single production run, and other production and shipping delays. These factors, in combination with continuing uncertainty in world financial markets, also served to reduce or delay the securing of certain customer orders. These external forces, both individually and collectively, impacts negatively upon the Company's operating results and upon the timing and amount of the Company's cash flows. While the Company will continue to grow its sales revenue and is hopeful that these unfavourable market factors will stabilize or improve it remains difficult to project the extent of the profitability, if any, which may result from operations in the immediate future.

In spite of these unfavourable market factors, and in spite of the loss realized for the year, the Company was still able to generate positive cash flow from operations and to improve its cash position in 2011. The delays experienced in the receipt of electronic components resulted in the deferral, reduction or complete cancellation of certain customer orders during the year. This correlated directly with delays, reductions and elimination of the Company's ability to bill customers and to collect upon those billings. The negative impact on cash inflows is undesirable on its own but it becomes even less desirable when combined with increases in cash outflows due to associated incremental costs. The Company's ability to overcome these factors and manage its cash flow in such a way as to enable the generation of positive cash flow for the year is certainly a positive result.

One of the elements of managing cash flow is to ensure that available cash is utilized in a manner that benefits the Company in both the short term and in the longer term. During the year the Company not only made all scheduled payments to debt holders but also managed to take advantage of pre-payment options to pay an extra \$90,000 in principal payments. This provides immediate benefits by reducing interest costs and eliminates the need to make certain future payments. Clearly all aspects of this are positive but a by-product of this is that the maturity dates of these debts are accelerated which serves to increase the current portion of long term debt. During 2011 the current portion of long term debt rose by \$112,598 and the effect of this is to reduce working capital or increase a working capital deficiency. The Company's working capital deficiency rose by \$67,472 in 2011 which is clearly less than the increase in current portion of long term debt. It would appear therefore that the Company has experienced an unfavourable consequence of otherwise favourable debt reduction.

During 2011 the Company repaid a total of \$208,194 in long term debt and experienced a reduction of \$211,016 in total liabilities. The Company also completed a private placement financing that enabled the deficiency in assets to be reduced, in spite of the losses for the year which caused an increase in the deficit. Raising new capital and achieving debt reduction are both favourable results. However, certain of the debts that were reduced also constitute an element of the Company's capital under management. During the 2011 year these particular debts were reduced by \$148,540, including the optional pre-payments of \$90,000 mentioned above. During 2011 the Company's capital under management declined by \$86,658 and created a capital deficiency. Given that the reduction in capital is less than the optional debt pre-payment it would appear once again there is an unfavourable consequence of otherwise favourable debt reduction.

Admittedly, any fiscal year in which a Company reports a loss from operations and a net loss for the year is not going to be portrayed as successful under any circumstances. It would appear however that 2011 is a year that can be portrayed as being almost successful. 2011 was clearly a year in which many favourable results were achieved and where some positive actions led directly to some unfortunate financial measurements. The Company will continue to grow its sales, to strive for enhanced profitability, and to manage its liquidity risk and will endure the odd unfortunate impact should it arise.

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### Corporate Performance - continued

The following data may provide some additional insights relative to the Company's operating performance and financial position:

	For the fiscal years ended:				
	<u>June 11</u>	<u>June 10</u>	<u>June 09</u>		
Total Revenues	4,010,068	3,837,630	3,435,283		
Net (loss) income from operations	(178,066)	266,210	(165,302)		
Per share <sup>(1)</sup>	(0.031)	0.051	(0.031)		
Net (loss) income for the period	(180,359)	380,613	(196,656)		
Per share	(0.031)	0.072	(0.037)		
Total assets	2,106,570	2,255,703	2,119,699		
Total long-term financial liabilities	1,051,125	1,352,187	1,390,403		
Total liabilities	2,575,438	2,786,454	3,037,900		
	For the three month periods ended:				
	<u>June 11</u>	<u>Mar. 11</u>	<u>Dec. 10</u>	<u>Sept. 10</u>	<u>June 10</u>
Total Revenues	957,817	820,976	1,112,951	1,118,324	1,408,769
Net (loss) income from operations	(100,165)	(117,154)	(51,768)	91,021	267,162
Per share <sup>(1)</sup>	(0.014)	(0.022)	(0.010)	0.017	0.051
Net (loss) income for the period	(98,320)	(117,154)	(51,768)	86,883	381,565
Per share <sup>(1)</sup>	(0.014)	(0.022)	(0.010)	0.017	0.073
Total assets	2,106,570	2,299,219	2,212,766	2,250,671	2,255,703
Total long-term financial liabilities	1,051,125	1,173,917	1,227,289	1,115,540	1,352,187
Total liabilities	2,575,438	2,712,514	2,639,707	2,694,540	2,786,454
	For the three month periods ended:				
	<u>Mar. 10</u>	<u>Dec. 09</u>	<u>Sept. 09</u>	<u>June 09</u>	<u>Mar. 09</u>
Total Revenues	888,849	777,838	762,174	785,581	690,777
Net (loss) income from operations	48,105	(19,073)	(29,984)	(180,183)	(26,845)
Per share <sup>(1)</sup>	0.009	(0.004)	(0.006)	0.035	(0.005)
Net (loss) income for the period	48,105	(19,073)	(29,984)	(211,537)	(26,845)
Per share <sup>(1)</sup>	0.009	(0.004)	(0.006)	(0.041)	(0.005)
Total assets	1,895,045	1,918,100	1,959,494	2,119,699	1,291,890
Total long-term financial liabilities	1,348,797	1,350,369	1,416,359	1,390,403	474,187
Total liabilities	2,814,543	2,884,984	2,907,491	3,037,900	2,084,721

There were no cash dividends paid or accrued during any of the periods noted above.

<sup>(1)</sup> Earnings per share figures for each period have been restated to give retroactive effect to the share consolidation transaction that occurred April 2010.

### Results of Operations

The Company has reported a net loss from operations of \$178,066 for the 2011 fiscal year including a loss of \$100,165 that arose in the final quarter. In comparison, the Company reported net income from operations of \$266,610 for the 2010 fiscal year as a consequence of realizing income of \$267,162 during the fourth quarter. While revenue growth in the current year has certainly helped to generate improved profitability there were also other factors that contributed to the losses incurred in 2009. The largest item would be the amortization arising from new equipment acquired in May 2009. In accordance with Company policy, the amortization recognized in the year that equipment is installed and available for use is equal to ½ of the annual depreciation regardless of the date the asset was actually acquired. In this instance the Company recognized six months of depreciation in the final quarter of 2009 resulting in an increase of approximately \$96,000 in comparison to the amortization recognized in previous quarters. Given that the equipment was only available for use during the final month of the year, and that its practical applicability in that month was limited due to how new it was, the impact on 2009 income was substantial.

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### **Results of Operations - continued**

Product sales for the 2011 year amounted to \$4,010,068 which represents the second highest annual sales figure realized since operations became focussed on the assembly of printed circuit boards. The highest annual sales figure arose in 2008 and amounted to \$4,066,835. Prior to 2011, the second highest figure for annual sales had arisen in 2010 when they amounted to \$3,837,630. The 2010 sales figure included \$1,408,769 which arose during an exceptional fourth quarter which represents the highest quarterly sales figure that the Company has reported to date. Although sales in Q4 2011 were quite strong at \$957,817 they do not compare favourably to the record sales from one year earlier. The increase in annual sales realized in 2011 is attributed to a rise in turnkey sales and the corresponding revenue derived from the supply of components. Management is confident that the relative demand for turnkey sales will remain strong heading into the 2012 fiscal year but is also aware that the inconsistent market conditions will continue to have an impact on product sales.

The gross margin realized in 2011 amounted to \$1,366,584 or 34.1% of product sales. This represents a decline of \$198,111 in comparison to 2010 levels when the gross margin was approximately 40.8% of sales. While lower, the 2011 margins are within expectations for a period with a significant portion of revenues derived from turnkey sales. 2010 was the first fiscal year for which the gross margin exceeded 40% of annual sales. This was made possible by the high margin realized during the fourth quarter of 2010 when economies of scale attributable to record sales led to a gross margin of \$646,254. That figure represented 45.9% of sales and also accounted for more than 41% of the total gross margin for the year. The gross margin realized during the final quarter of 2011 was \$333,479 representing a more traditional 35% of sales and 24.4% of the annual gross margin. The gross margin to be realized in future periods will continue to be affected by product mix and by inconsistent market conditions but management currently anticipates that future margins will be fairly comparable with the more traditional results of 2011.

The best indicator of the volume of turnkey sales and of product mix is the cost for electronic components provided by the Company during a particular period. During 2011 this cost amounted to \$1,090,459 which represents an increase of almost 22% in comparison to the 2010 total of \$894,012 and supports that turnkey volumes rose in 2011. This cost was equal to 41.3% of sales revenue in 2011 as compared to 39.3% in 2010 and this supports that turnkey sales represented a larger portion of total product sales in 2011. An examination of fourth quarter results indicates that component costs declined from \$351,672 in 2010 to \$281,834 in 2011 but rose from 25% of sales in 2010 to 29.4% in 2011. Although an increase in component costs as a percentage of sales translates into a decline in the gross margin percentage the Company promotes this service on the basis that it provides economic benefit to the Company while simultaneously providing a cost effective solution for its customers.

There are two significant elements of costs of sales. The cost of electronic components is one and the other is direct labour. In combination these cost factors represent more than 80% of the total cost of goods sold in each period. Actual direct labour expenditures for the 2011 fiscal year amounted to \$1,083,418 but the amount of labour included in costs of goods sold was \$1,091,643 due to a decline during the year in the amount of labour costs included as an element of the cost of inventory. For the 2010 fiscal year the labour expenditures amounted to \$889,884 with the aggregate labour charges in cost of product sales amounting to \$907,517. During the first three quarters of the 2010 fiscal year the Company was operating below capacity and took advantage of government sponsored work-share programs to reduce their staff complement and the associated costs. This reduction of the labour force ended late in the third quarter of 2010 and resulted in fourth quarter labour expenditures of \$265,240 and aggregate labour charges of \$276,378. No work-share program was implemented at any time during the 2011 fiscal year and there was no reduction in customer demand that suggested that a permanent workforce reduction was warranted. The maintaining of the staff complement throughout 2011 resulted in the higher annual costs and in reasonably comparable fourth quarter amounts. Labour expenditures in Q4 2011 were \$250,359 and aggregate labour charges for the period were \$247,404. Work-share programs enable the retention of these trained employees but at a reduced cost to the Company and allows production capacity to be better matched to short-term fluctuations in production demand. A similar work-share program was initiated in the first quarter of 2012 and should result in reduced labour costs for that period.

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### **Results of Operations - continued**

Equipment costs, which include amortization and maintenance costs, amounted to \$261,409 in 2011 as compared to \$305,285 in 2010. Maintenance costs rose slightly from \$53,313 to \$58,744 while amortization charges fell from \$251,972 to \$202,655. In Q4 2011 the Company incurred \$10,994 in maintenance costs and \$50,722 in amortization charges for total machinery costs of \$61,716. Each of these figures was higher in 2010 when the total of \$87,215 was comprised of \$64,084 in amortization charges and \$23,131 in maintenance costs. Although the Company follows a standard maintenance program for all of its equipment it is not feasible to standardize the timing or nature of all maintenance costs. Also, while every effort is made to minimize unscheduled maintenance it cannot be completely prevented. These factors can and will lead to fluctuations over relatively short periods like a fiscal quarter but the inconsistencies will be less evident when observed over a longer period like an entire fiscal year. Amortization charges decline over time unless significant new equipment is acquired. There were no significant equipment purchases made in either 2010 or 2011 so the decline experienced was anticipated. Although one piece of equipment has been added to the production line during the first quarter of 2012 its cost is not sufficiently large to cause an increase in amortization charges.

Production supplies represent products that are consumed during the production process but are not of sufficient individual cost to warrant tracking through the Company's inventory system. These costs amounted to \$112,148 for 2011 including \$17,056 incurred in the final quarter. During 2010 these costs were \$90,469 including the fourth quarter total of \$24,084. Although the acquisition of supply items is subject to the Company's purchase control procedures the costs incurred in any given period is a function of when the purchase occurs which is not necessarily in the same period in which the items are consumed. While this may lead to some minor inconsistencies in the periodic expenses there is no intent to increase the cost tracking detail since the cost of doing so would exceed the benefit derived.

The remainder of the cost of product sales for each period is made up of freight costs, tooling costs and the cost of packaging supplies. The aggregate of these costs represents less than 4% of the quarterly and annual cost of product sales totals in both 2011 and 2010. These expenses are continuously monitored by management and do not warrant detailed investigation or elaboration.

Selling, general and administrative expenses ("SG&A") are all costs incurred by the Company that are not directly attributable to the production process or to the cost of financing. These costs amounted to \$1,340,392 in 2011 representing an increase of 20.4% over the 2010 total of \$1,112,964. Fourth quarter figures are also higher in 2011 when they aggregated \$350,301 as compared to \$333,675. There are many components of SG&A and management continuously monitors each of them to ensure that they are both necessary and reasonable in the circumstances.

The largest single element of SG&A for each period is employee and consultant remuneration. These costs followed a similar pattern to direct labour costs as the annual expense rose from \$652,112 in 2010 to \$866,279 in 2011. In 2010 the administrative personnel were subjected to pay reductions and to a similar work-share program as was implemented for the production staff. The work-share program persisted through the first three quarters of 2010 leading to significantly reduced costs. The 2011 total also includes \$68,696 in stock option compensation associated with the issuance of stock options to Directors and Senior Officers. In 2010 stock option compensation amounted to \$732 on account of the vesting of options that had been granted back in 2006. Fourth quarter figures are more comparable but the 2011 total of \$219,837 is still greater than the 2010 figure of \$206,621. Although the work-share program was terminated prior to Q4 2010 the salary reductions remained in effect. At the end of the quarter the Company approved non-recurring bonuses based upon corporate performance and reinstated the salaries to historical levels. The total for Q4 2011 not only reflects the higher salary figure but also includes the costs of settling with a terminated employee. It is anticipated that 2011 figures will be indicative of future costs.

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### **Results of Operations - continued**

Occupancy costs are the next largest element of SG&A and consist primarily of rent and utility charges. During the 2011 fiscal year the Company negotiated a new ten year lease for its operating facility. This new lease included base rental rates which escalate over the term of the lease but always remain lower than the final base rates were on the expiring lease. The new rates took effect at the beginning of the third fiscal quarter of 2011 and contributed to the decline in total annual costs from \$307,466 to \$303,955. The benefit of the reduction in base rates was eroded to some degree by seemingly inevitable increases in additional rent charges for realty taxes and maintenance. The utility usage and rates also continue to vary with the trend being for costs to rise each year. Occupancy costs incurred in the fourth quarter of 2010 amounted to \$82,540 but included approximately \$6,500 in costs that carried over from the preceding quarter as a consequence of a utility billing delay. The expense for Q4 2011 amounted to \$71,188.

Professional fees for the 2011 fiscal year amounted to \$77,415 which is \$15,617 higher than the 2010 total of \$61,798. During the year the Company prepared for a possible financing transaction that was not completed and negotiated a bank operating loan facility which is secured, in part, by the personal guarantee of an unrelated individual. The increase in professional fees is a reflection of the legal fees attributable to these two transactions as nothing similar arose in 2010. It should be noted that the Company did complete a private placement transaction in 2011 but there is no incremental legal expense associated with that transaction. The bank operating loan was obtained in the fourth quarter of 2011 and this certainly contributed to the total professional fees of \$34,127 for that period and to the increase over the expense of \$20,715 incurred in Q4 2010.

Regulatory fees include all stock exchange and transfer agent fees incurred. The Company completed a 12:1 share consolidation in April 2010 and saw its regulatory fees rise to \$40,342 in the 2010 fiscal year as a result. No similar transaction arose in 2011 and as a result the fee total of \$25,758 is almost identical to the 2009 expense of \$25,233 as was expected. Most of the fees associated with the April 2010 consolidation were incurred in the third quarter of 2010 and did not impact upon the final quarter when costs amounted to \$11,086. The costs for Q4 2011 were comparable at \$12,872. It should be noted that a disproportionate amount of the annual costs arise in the final quarter as a result of hosting the Company's annual general meeting during that period.

The remaining elements of SG&A are individually insignificant and, in aggregate, represent less than 5% of total SG&A for the 2011 and 2010 fiscal years and for the fourth quarter of each year. These expenses are continuously monitored by management and do not warrant detailed investigation or elaboration.

Interest on long-term debt declined to \$147,119 in 2011 from \$160,123 in 2010 and from \$39,918 in Q4 2010 to \$35,317 in the fourth quarter of 2011. The Company incurred no new long-term debts during the 2011 fiscal year and repaid \$208,194 in long term debt during the year. The Company also repaid \$227,810 in long term debt during 2010 while receiving \$7,132 in new proceeds. The reduction in long-term debt resulting from these repayments is the reason why interest costs have declined and are expected to fall further in future periods. It should be noted that the carrying value of long term debt does not decline in any period by an amount equal to the principal repaid. This is due to certain debts having a carrying value that is less than their cash or face value. This difference between face value and carrying value is accreted each period such that the two values will be identical as at the maturity date of the debt. Accretion charges of \$19,730 arose in fiscal 2011 and \$18,711 in fiscal 2010. These figures are included as an element of interest expense.

By June 30, 2010 the Company had extinguished all of its short term debts and as a result it only incurred \$299 in other interest charges in 2011. These charges arose as a consequence of opting to pay insurance costs monthly rather than annually and included \$150 in charges that arose in the fourth quarter. The 2010 expense of \$11,147, including \$465 in Q4, was attributable to interest on notes payable which arose before they were finally settled. With the negotiation of the bank operating facility there is no expectation of utilizing notes payable as a means of short term financing in the foreseeable future.

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### Results of Operations - continued

The costs associated with the aforementioned bank operating facility have been segregated from other interest and are reflected as financing fees. The 2011 expense, all of which arose in the fourth quarter, includes the value of \$42,746 attributed to the share purchase warrants issued to the guarantor plus \$1,600 in guarantee fees. The guarantor is entitled to a monthly guarantee fee of \$800 in addition to interest charged on the outstanding loan balance, if any, equal to the difference between 10% and the amount paid to the bank based upon a lending rate of prime plus 0.5%. As of the date of this document the Company has yet to draw upon this operating loan.

### Liquidity

For the first time in five fiscal years the Company has experienced an increase in its working capital deficiency. It rose from \$220,226 at June 2010 to \$287,698 as at June 30, 2011. As noted previously, this increase arose because the aggregate improvement in other working capital items was not sufficient to offset the increase in current portion of long term debt that arises when debts proceed towards maturity. The Company generated positive cash flow from operations is confident that combining favourable cash flows with continued debt reduction will lead to improved liquidity in future periods.

There is a balance of \$742,056 included in current liabilities on account of preferred shares and the associated dividends. These amounts are non-interest bearing, are not secured and it is not currently known how or when these obligations may be settled. The preferred shares are not entitled to any further dividends and this balance has not changed since the final quarter of the 2007 fiscal year.

The Company currently utilizes long term debt as a means of financing new equipment acquisitions and of settling other obligations whenever suitable terms can be negotiated. The Company's short-term financing requirements, if any, are now expected to be met through the bank operating line.

In addition to satisfying the cost of operations the Company must also address the payment or other settlement of the following amounts which are presented at face value, as at June 30, 2011, without discount:

	Due by <u>June 2012</u>	Due by <u>June 2014</u>	Due by <u>June 2016</u>	Due after <u>June 2016</u>	Total <u>Due</u>
Repurchase of preferred shares <sup>(1, 2)</sup>	\$ 665,501	\$ -	\$ -	\$ -	\$ 665,501
Settlement of dividends payable <sup>(1)</sup>	268,201	-	-	-	268,201
Debenture <sup>(1)</sup>	39,600	-	-	-	39,600
Other long-term debt <sup>(3, 4)</sup>	230,290	1,034,769	46,806	-	1,311,865
Operating leases	<u>83,297</u>	<u>175,195</u>	<u>186,965</u>	<u>499,555</u>	<u>945,012</u>
Total	<u>\$ 1,286,889</u>	<u>\$ 1,209,964</u>	<u>\$ 233,771</u>	<u>\$ 499,555</u>	<u>\$ 3,230,179</u>

<sup>(1)</sup> Each of these amounts were past due as at June 30, 2011

<sup>(2)</sup> The repurchase price includes \$473,855 reported as an element of current liabilities plus \$191,646 in paid up capital that is reported as an element of share capital.

<sup>(3)</sup> Other long-term debt includes three obligations that each has a carrying value that is lower than their respective face values. The financial statements as at June 30, 2011 report these obligations based upon their carrying values while the figures reported above represent the non-discounted cash payments to be made in accordance with the face value amounts.

<sup>(4)</sup> On September 30, 2011 the Company paid a \$30,000 principal pre-payment on one loan. The effects of this payment have not been reflected in this table.

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### Capital Resources

In May 2011 the Company obtained a \$250,000 revolving line of credit from its financial institution. The loan, which has not been drawn upon, bears interest at the prime lending rate plus 0.5%, is due upon demand, matures May 13, 2103, and is secured by a general security agreement covering the assets of Permotech Electronics Corporation and by the personal guarantee of an individual that is not related to the Company. The Company issued 500,000 share purchase warrants to the guarantor with each warrant entitling them to acquire one common share of the Company at a price of \$0.135 until the earlier of May 18, 2013 and the date when the guarantee is removed. If the borrowing limit of the credit line is reduced prior to May 18, 2012 then the number of warrants will be reduced on a pro rata basis within thirty days of the reduction. The guarantor will also be paid a fee of \$800 per month and will receive interest, based upon the amount drawn from time to time on this line of credit, equal to 10% less the interest at prime plus 0.5% that is payable to the Company's financial institution.

In March 2011 the Company completed a financing transaction whereby it issued 1,800,000 units at \$0.075 each for gross proceeds of \$135,000. Each unit was comprised of one common share and one-half share purchase warrant with each full warrant entitling the holder to acquire an additional common share for \$0.135 until March 24, 2016. The Company paid a finder's fee in the amount of \$4,200 in connection with this transaction.

No additional financing transactions were completed during the fiscal year or up to the date of this document.

The Company currently has no formal arrangement with any party to provide financing for capital acquisitions.

### Related Party Transactions

The Company has participated in a number of transactions with the Company's Officers, Directors, their spouses, companies that are considered related as a consequence of the involvement of one or more of these individuals, and a corporation that holds more than 10% of the Company's issued common shares.

The majority of these related party transactions involve the provision of financing to the Company along with the corresponding interest expense. All related party transactions are in the normal course of operations and have been carried out on the same terms as those accorded to unrelated parties.

The following balances are due to the related parties described above as at June 30 of each year:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Loan payable at prime +8% <sup>(1)</sup>	131,540	199,042	-
Note payable at prime +2%	-	-	-
Notes payable at 12.0%	-	-	116,572
Term loan at 8.0%	-	-	37,871
Term loans at 12.0%	-	-	161,383

<sup>(1)</sup> This is the face value of this obligation. It is reported in the financial statements at a discounted value.

The following income and expense items have arisen as a result of transactions involving the related parties defined above:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Interest expense – long term	21,030	22,854	20,981
Interest expense – other	-	9,002	14,588



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**Related Party Transactions - continued**

The following stock options have been issued to Directors and/or Officers of the Company and remain outstanding as at the date of this document:

<u>Description</u>	<u>Expiry Date</u>	<u>Number of Common shares</u>
Stock options @ \$0.10 per share	Nov. 2015	900,000

An additional 75,000 stock options that had been held by Directors and/or Officers of the Company expired during the 2011 fiscal year.

**Convertible Instruments and Other Securities**

As at June 30, 2011, and as at the date of this document, the Company had the following securities issued and outstanding:

<u>Description</u>	<u>Quantity</u>	<u>Amount</u>
Common shares	7,062,488	\$ 21,773,391
Paid in capital of preferred shares		191,646
Class A special shares	1,193,442	<u>100,000</u>
		<u>\$ 22,064,037</u>
Series A preferred shares	166,667	\$ 160,000
Series C preferred shares	288,858	<u>505,501</u>
		665,501
Less: amount accounted for as paid in capital		<u>191,646</u>
Liability element of preferred shares		473,855
Less: amount reported as a current liability		<u>(473,855)</u>
Equity element of preferred shares		<u>\$ -</u>

<u>Description</u>	<u>Expiry Date</u>	<u>Number of Common shares</u>
Stock options @ \$2.04 per share	June 2011	75,000
Warrants @ \$0.135 per share <sup>(1)</sup>	May 2013	500,000
Stock options @ \$0.10 per share	Nov 2015	900,000
Warrants @ \$0.10 per share	Mar 2016	<u>900,000</u>
Shares reserved as at June 30, 2011 and as at the date of this document		<u>2,375,000</u>

<sup>(1)</sup> These warrants will expire on the earlier of May 18, 2013 and the date that the Company eliminates the guarantee that the holder has provided as security for the Company's line of credit. If the borrowing limit of the Company's credit line is reduced from \$250,000 prior to May 18, 2012 then the number of warrants will be reduced on a pro-rata basis within thirty days of the reduction. These warrants are also subject to claw-back provisions as may be imposed by the TSX Venture Exchange.

Shares issued	7,062,488
Shares reserved	<u>1,875,000</u>
Fully diluted position as at June 30, 2011 and as at the date of this document	<u>9,437,488</u>

## ZTEST Electronics Inc.

Management's Discussion and Analysis

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(Prepared as at October 20, 2011)

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### **Convertible Instruments and Other Securities - continued**

Additional disclosures relative to stock options are as follows:

	Common Shares <u>Under Option</u>	Weighted Average <u>Price/Option</u>	Weighted Average <u>Expiry Date</u>
Beginning of period	79,167	\$2.031	June 8, 2011
Expired	(79,167)	\$2.031	June 8, 2011
Granted	<u>900,000</u>	\$0.100	Nov. 30, 2015
End of period	<u>900,000</u>	\$0.100	Nov. 30, 2015

While all remaining stock options are held by related parties the Company has no ability to cause them to be exercised.

Additional disclosures relative to share purchase warrants are as follows:

	Number of <u>Warrants</u>	Weighted Average <u>Price/Warrant</u>	Weighted Average <u>Expiry Date</u>
Beginning of period	-	-	-
Issued during the period	<u>1,400,000</u>	\$0.113	Mar. 18, 2015
End of period	<u>1,400,000</u>	\$0.113	Mar. 18, 2015

### **Changes in Accounting Policy**

The accounting policies followed by the Company are established in accordance with Canadian GAAP and once policies are established they will not, as a matter of policy, be revised unless Canadian GAAP changes. The following aspects of Canadian GAAP will be changing in the future and, accordingly, will cause the Company's accounting policies to change:

#### *International reporting standards:*

The Accounting Standards Board ("AcSB") requires that all public entities transition to International Financial Reporting Standards (IFRS) from Canadian GAAP for fiscal years commencing on or after January 1, 2011. Accordingly, the Company will begin reporting in accordance with IFRS for its fiscal year ended June 30, 2012 and the first report to be issued in under IFRS will be the interim financial statements for the period ended September 30, 2011. It is currently anticipated that this transition will result in additional disclosures but that it will not result in any revision to, or restatement of, the carrying value of any assets or liabilities or the amounts of any revenues or expenses presented in these financial statements.

### **Financial Instruments**

The Company has determined the most appropriate classification for its financial instruments such that cash is classified as held for trading and is measured at fair value. Accounts receivable has been classified as loans and receivables and accounts payable, accrued liabilities, customer deposits, deferred revenue, dividends payable, notes payable, long-term debt and preferred shares are classified as other financial liabilities, which are measured at amortized cost. These classifications have remained unchanged since initial recognition.

The carrying amounts of cash, accounts receivable, customer deposits and deferred revenue, accounts payable and accrued liabilities, and notes payable approximate their fair values due to the short-term maturities of these instruments. Long-term debt is recognized initially at fair value. The difference between face value and initial fair value, if any, is amortized on a straight line basis over the remaining term of the debt. It is not practicable to determine the fair value of preferred shares or dividends payable since the timing of cash flows are not known.

## **ZTEST Electronics Inc.**

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### **Risk Factors**

Events seemingly unrelated to us, or to our industry, may adversely affect our finances or operations in ways that are hard to predict or defend against. For example, credit contraction in financial markets may hamper our ability to access credit when needed or rapid changes in foreign exchange rates may adversely affect our financial results. Finally, a reduction in credit, combined with reduced economic activity, may adversely affect businesses and industries that constitute a significant portion of our customer base. As a result, these customers may need to reduce purchases from us, or we may experience greater difficulty in collecting amounts due from them. Any of these events, or others caused by uncertainty in world financial markets, may have a material adverse effect on our business, operating results, and financial condition.

In addition to the foregoing, the Company is exposed to credit risk, liquidity risk, currency risk, and interest rate risk. The Company's primary risk management objective is to protect earnings and cash flow and, ultimately, shareholder value. Risk management strategies, as discussed below, are designed and implemented to ensure that the Company's risks and the related exposure are consistent with its business objectives and risk tolerance. There have been no changes to the risks to which the Company is exposed or to the corresponding risk management strategies during the current period.

#### **Credit risk:**

Credit risk represents the financial loss that the Company would experience if one or more of its customers failed to meet its obligations. The maximum credit exposure is represented by the carrying amount of accounts receivable as reported on the balance sheet. In an effort to mitigate this risk, management actively manages and monitors its receivables and obtains pre-payments where warranted. Bad debt experience has not been significant and it has been determined that no allowance is required as all amounts outstanding are considered collectible.

#### **Liquidity risk:**

Liquidity risk represents the potential difficulties that the Company may encounter in meeting obligations associated with financial liabilities. The Company is reporting a working capital deficiency of \$287,698 (2010 - \$220,226). This includes a long-term debt, preferred shares and dividends payable with an aggregate carrying value of \$781,656 (2010 - \$781,656), that are each past due. The Company manages its liquidity risk through the management of its capital (see Note 11) which incorporates the continuous monitoring of actual and projected cash flows to ensure that it has sufficient liquidity to meet its operating commitments without incurring unacceptable losses or risking damage to the Company's reputation.

#### **Currency risk:**

Currency risk is the risk that the amount of future cash flows of cash, accounts receivables, accounts payable and accrued liabilities that are denominated in US dollars will fluctuate because of changes in foreign exchange rates. The Company purchases some inventory components and makes some of its product sales in US dollars. The Company monitors its exposure to, but does not actively manage this risk. During the current year the Company reported a net loss on foreign exchange of \$2,049 (2010 - \$2,132).

#### **Interest rate risk:**

Interest rate risk represents the possibility that future cash flows arising from financial instruments may fluctuate because of changes in the market rate of interest. The Company has certain long-term debts for which the interest rate is reset periodically in accordance with the prime lending rate of its financial institution. The future monthly payments on these debts will increase or decrease in correlation with the change, if any, in the prime lending rate. The Company manages this risk by establishing fixed interest rates whenever possible.