

Xebec Adsorption Inc.

Condensed Interim Consolidated Financial Statements
(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

The Condensed Interim Consolidated Financial Statements which are included in this Report have not been subject to a review by the Company's External Auditors.

Xebec Adsorption Inc.

Interim Consolidated Statement of Financial Position (Unaudited)

(expressed in Canadian dollars)

	As at March 31, 2011 \$	As at December 31, 2010 \$	As at January 1, 2010 \$
Assets			
Current assets			
Cash and cash equivalents	861,490	2,262,273	5,447,702
Trade and other receivables	2,336,997	2,603,261	3,105,834
Inventories	3,080,588	2,720,060	2,867,922
Income taxes recoverable	-	-	62,492
Investment tax credits receivable	2,673	103,489	80,843
Restricted cash	897,500	576,092	223,261
Other current assets	79,101	100,846	183,564
Total current assets	7,258,349	8,366,021	11,971,618
Non-current assets			
Loan to a joint venture	117,222	117,811	113,331
Property, plant and equipment	1,782,040	1,908,442	2,545,789
Intangible assets	4,354,126	4,483,897	5,222,797
Goodwill	342,616	342,616	342,616
Total non-current assets	6,596,004	6,852,766	8,224,533
Total assets	13,854,353	15,218,787	20,196,151
Liabilities			
Current liabilities			
Bank overdraft	500,000	500,000	496,900
Trade payables and accrued liabilities	5,907,408	7,089,760	4,586,203
Deferred revenues	2,724,771	2,331,802	146,228
Income taxes payable	-	8,286	-
Derivative financial instruments	-	-	96,645
Current portion of long-term debt	128,061	87,151	321,653
Current portion of subordinated loan	140,632	156,256	62,496
Provisions	653,542	1,036,095	141,309
Total current liabilities	10,054,414	11,209,350	5,851,434
Non-current liabilities			
Long-term debt	1,806,788	1,867,870	1,763,496
Government royalty program obligation	743,375	691,539	1,137,307
Government assistance	30,833	32,083	37,083
Provisions	304,030	304,034	694,674
Subordinated loan	-	-	156,256
Total non-current liabilities	2,885,026	2,895,526	3,788,816
Total liabilities	12,939,440	14,104,876	9,640,250
Shareholders' Equity			
Share capital	19,964,218	19,964,218	18,107,821
Contributed surplus	1,842,166	1,841,741	51,368
Accumulated other comprehensive income	99,739	72,622	-
Deficit	(20,991,210)	(20,764,670)	(7,603,288)
Total shareholders' equity	914,913	1,113,911	10,555,901
Total liabilities and shareholders' equity	13,854,353	15,218,787	20,196,151

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

Approved by the Board of Directors

Director

Director

Xebec Adsorption Inc.

Interim Consolidated Statement of Loss (Unaudited)

(expressed in Canadian dollars)

	For the three-month period ended March 31, 2011 \$	For the three-month period ended March 31, 2010 \$
Revenue	4,051,531	1,991,650
Cost of goods sold	2,037,473	1,873,353
Gross margin	2,014,058	118,297
Research and development expenses	351,680	542,892
Selling and administrative expenses	1,883,933	2,610,279
Foreign exchange loss (gain)	(108,460)	197,454
	2,127,153	3,350,625
Finance income	(3,593)	(6,900)
Finance expense	117,038	141,994
Finance costs – net	113,445	135,094
Loss before income taxes	(226,540)	(3,367,422)
Income taxes	-	-
Net loss for the period	(226,540)	(3,367,422)
Loss per share Basic and diluted	(0.00)	(0.11)

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

Xebec Adsorption Inc.

Interim Consolidated Statement of Comprehensive Loss (Unaudited)

(expressed in Canadian dollars)

	For the three-month period ended March 31, 2011 \$	For the three-month period ended March 31, 2010 \$
Net loss for the period	(226,540)	(3,367,422)
Other comprehensive income		
Cumulative translation adjustment	27,117	21,898
Comprehensive loss for the period	<u>(199,423)</u>	<u>(3,345,524)</u>

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

Xebec Adsorption Inc.

Interim Consolidated Statement of Changes in Shareholders' Equity (Unaudited)

(expressed in Canadian dollars)

	Number		Amount				
	Common shares	Warrants	Share capital – Common shares and warrants \$	Contributed surplus \$	Accumulated other comprehensive income \$	Deficit \$	Total \$
Balance – January 1, 2011	39,363,867	15,456,424	19,964,218	1,841,741	72,622	(20,764,670)	1,113,911
Net loss for the period	-	-	-	-	-	(226,540)	(226,540)
Other comprehensive income (net of tax)	-	-	-	-	27,117	-	27,117
Comprehensive loss for the period	-	-	-	-	27,117	(226,540)	(199,423)
Share-based compensation	-	-	-	425	-	-	425
Balance – March 31, 2011	39,363,867	15,456,424	19,964,218	1,842,166	99,739	(20,991,210)	914,913
Balance – January 1, 2010	29,262,445	17,167,824	18,107,821	51,368	-	(7,603,288)	10,555,901
Net loss for the period	-	-	-	-	-	(3,367,422)	(3,367,422)
Other comprehensive income (net of tax)	-	-	-	-	21,898	-	21,898
Comprehensive loss for the period	-	-	-	-	21,898	(3,367,422)	(3,345,524)
Share-based compensation	-	-	-	6,598	-	-	6,598
Balance – March 31, 2010	29,262,445	17,167,824	18,107,821	57,966	21,898	(10,970,710)	(7,216,975)

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

Xebec Adsorption Inc.

Interim Consolidated Statement of Cash Flows (Unaudited)

(expressed in Canadian dollars)

	For the three-month period ended March 31, 2011 \$	For the three-month period ended March 31, 2010 \$
Cash flows generated from (used in)		
Operating activities		
Net loss for the period	(226,540)	(3,367,422)
Adjustments for:		
Depreciation of property, plant and equipment	117,030	188,280
Amortization of intangible assets	129,503	138,138
Government assistance	(1,250)	(1,250)
Unrealized foreign exchange loss on derivative financial instruments	-	76,318
Unrealized foreign exchange loss on loan to a joint venture and restricted cash	588	19,242
Accretion of government royalty program obligation	51,836	85,269
Share-based compensation expense	425	6,598
	<u>71,592</u>	<u>(2,854,827)</u>
Changes in items of working capital		
Trade and other receivables	266,264	1,276,825
Inventories	(360,528)	(185,724)
Other current assets	21,745	(9,073)
Investment tax credits receivable	100,816	15,626
Trade payables and accrued liabilities	(1,182,352)	(277,905)
Deferred revenues	392,969	2,024,692
Income taxes payable (recoverable)	(8,286)	32,637
Other operating liabilities	(382,557)	(324,974)
	<u>(1,151,929)</u>	<u>2,552,104</u>
Net cash used in operating activities	<u>(1,080,337)</u>	<u>(302,723)</u>
Investing activities		
Acquisition of property, plant and equipment	-	(7,298)
Proceeds from disposal of property, plant and equipment	8,428	-
Increase in restricted cash	(321,408)	-
Net cash used in investing activities	<u>(312,980)</u>	<u>(7,298)</u>
Financing activities		
Decrease in bank loan	-	(9,208)
Increase in long-term debt	9,568	99,867
Repayment of long-term debt	(45,364)	(87,333)
Repayment of Government royalty program obligation	-	(41,459)
Net cash used in financing activities	<u>(35,796)</u>	<u>(38,133)</u>
Net decrease in cash and cash equivalents during the period	<u>(1,429,113)</u>	<u>(348,154)</u>
Cash and cash equivalents – Beginning of period	2,262,273	5,447,702
Exchange gains on cash and cash equivalents	<u>28,330</u>	<u>32,519</u>
Cash and cash equivalents – End of period	<u>861,490</u>	<u>5,132,067</u>
Additional information		
Income tax recovered	-	(27,351)
Interest paid	51,157	68,208

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

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

1 Nature of business and liquidity risk

a) Nature of business

Xebec Adsorption Inc. (the “Company”) is a global provider of clean energy solutions to corporations and governments looking to reduce their carbon footprint. The Company was formed upon the amalgamation of Xebec Adsorption Inc. (“Xebec”) and QuestAir Technologies Inc. (“QuestAir”) on June 12, 2009. The Company is incorporated and domiciled in Canada. The address of its registered office is 730 Industriel Boulevard, Blainville, Quebec.

b) Going concern

These condensed interim consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assume the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. The Company has incurred an operating loss of \$226,540 for the three-month period ended March 31, 2011 (\$13,161,383 for the year ended December 31, 2010) and has a deficit of \$20,991,210 and a negative working capital of \$2,796,065 as at March 31, 2011 (\$20,764,670 and \$2,843,329 as at December 31, 2010). The current financial position indicates that there is doubt about the Company’s ability to continue as a going concern.

The Company’s ability to continue as a going concern is primarily dependent on its ability to generate sufficient future cash flows to fund its operations and to settle its obligations on a timely basis.

On March 17, 2011, the Company signed a licence and engineering service agreement amounting to US\$3,250,000, including an upfront payment of US\$1,750,000. In addition, the Company undertook various initiatives such as a cost reduction and return to profitability program to manage its operations and liquidity risks in light of prevailing economic conditions. There is no assurance that such efforts will be successful. However, and as a result of this plan, as of March 31, 2011, the net loss for the period is \$226,540, compared to a net loss of \$3,367,422 for the corresponding period as at March 31, 2010. Operating activities, before changes in items of working capital, generated \$71,592 as of March 31, 2011 compared to a use of \$2,854,827 for the corresponding period ended March 31, 2010.

These condensed interim consolidated financial statements do not reflect the adjustments to the carrying values of assets and liabilities, the reported expenses and the balance sheet classifications that would be necessary if the Company were unable to continue as a going concern, and these adjustments could be material.

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

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2 Basis of presentation

These condensed interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”) as set out in the Handbook of the Canadian Institute of Chartered Accountants (“CICA”). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards (“IFRS”), and publicly accountable enterprises are required to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Company has commenced reporting on this basis in these condensed interim consolidated financial statements. In the financial statements, the term “Canadian GAAP” refers to Canadian GAAP before the adoption of IFRS.

These condensed interim consolidated financial statements have been prepared in accordance with IFRS applicable to the preparation of interim financial statements, including IAS 34 and IFRS 1. Subject to certain transition elections disclosed in note 4, the Company has consistently applied the same accounting policies in its opening IFRS statement of financial position as at January 1, 2010 and throughout all periods presented as if these policies had always been in effect. Note 4 discloses the impact of the transition to IFRS on the Company’s reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in the Company’s consolidated financial statements for the year ended December 31, 2010.

The policies applied in these condensed interim consolidated financial statements are based on IFRS issued and outstanding as of June 13, 2011, the date the Board of Directors approved the statements, and effective on December 31, 2011. Any subsequent changes to IFRS that are given effect in the Company’s annual consolidated financial statements for the year ending December 31, 2011 could result in restatement of these condensed interim consolidated financial statements, including the transition adjustments recognized on change-over to IFRS.

The condensed interim consolidated financial statements should be read in conjunction with the Company’s Canadian GAAP annual financial statements for the year ended December 31, 2010. Note 4(iv) discloses IFRS information for the year ended December 31, 2010 not provided in the 2010 annual financial statements and considered material in understanding these condensed interim consolidated financial statements.

3 Significant accounting policies

Basis of measurement

These condensed interim consolidated financial statements have been prepared under the historical cost convention, except for the revaluation of certain financial assets and financial liabilities to fair value, including derivative instruments.

Xebec Adsorption Inc.

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Consolidation

These condensed interim consolidated financial statements include the accounts of the Company and its subsidiary, Xebec Adsorption (Shanghai) Co. Ltd. They also include the Company's portion of the accounts of a joint venture, Xebec Adsorption South East Asia PTE. Ltd., accounted for using the proportionate consolidation method. All intercompany transactions, balances and unrealized gains and losses from intercompany transactions are eliminated on consolidation.

Subsidiaries are those entities which the Company controls by having the power to govern the financial and operating policies. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Company controls another entity. Subsidiaries are fully consolidated from the date on which control is obtained by the Company and are deconsolidated from the date that control ceases.

The Company's interests in jointly controlled entities are accounted for by proportionate consolidation. The Company combines its share of the joint ventures' individual income and expenses, assets and liabilities and cash flows on a line-by-line basis with similar items in the Company's financial statements. The Company recognizes the portion of gains or losses on the sale of assets by it to the joint venture that is attributable to the other venturers. The Company does not recognize its share of profits or losses from the joint venture that result from the Company's purchase of assets from the joint venture until it resells the assets to an independent party. However, a loss on the transaction is recognized immediately if the loss provides evidence of a reduction in the net realizable value of current assets, or an impairment loss.

Cash and cash equivalents

In the consolidated statement of cash flows, cash and cash equivalents includes cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less and bank overdrafts. In the consolidated statement of financial position, bank overdrafts are shown in current liabilities.

Trade receivables

Trade receivables are amounts due from customers for merchandise sold or services performed in the ordinary course of business. If collection is expected in one year or less (or in the normal operating cycle of the business if longer), they are classified as current assets. If not, they are presented as non-current assets.

Trade receivables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less provision for impairment.

Inventories

Inventories are stated at the lower of cost and net realizable value for raw materials, work in progress and finished goods. Costs of raw materials are determined on an average cost basis. Work in progress and finished goods include materials, direct labour and production overhead (based on normal operating capacity). Net realizable value is the estimated selling price less applicable selling expenses. Inventories are recorded net of any obsolescence provision.

Xebec Adsorption Inc.

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A new assessment is made in each subsequent period when inventories are adjusted to net realizable value. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realizable value because of changed economic circumstances, the amount of the write-down is reversed (i.e., the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of cost and the revised net realizable value.

Property, plant and equipment

Property, plant and equipment are stated at 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 can be measured reliably. The carrying amount of a replaced asset is derecognized when replaced. Repairs and maintenance costs are charged to the statement of income during the period in which they are incurred.

The major categories of property, plant and equipment are depreciated on a straight-line basis as follows:

Building	20 years
Machinery and equipment	3 to 10 years
Office furniture and equipment	5 years
Computers	3 years
Moulds	5 years
Vehicles	5 years
Leasehold improvements	Lesser of economic life and term of lease

The Company allocates the amount initially recognized in respect of an item of property, plant and equipment to its significant parts and depreciates each such part separately. Residual values, method of depreciation and useful lives of the assets are reviewed annually and adjusted if appropriate.

Gains and losses on disposals of property, plant and equipment are determined by comparing the proceeds with the carrying amount of the asset and are included as part of other gains and losses in the statement of income.

Identifiable intangible assets

The Company's intangible assets include patents, customer relations, software and engineering drawings. These assets are capitalized and amortized on a straight-line basis in the statement of income over the period of their expected useful lives.

Patent costs are amortized using the straight-line method over fifteen years. Customer relations are amortized using the straight-line method over a period of seven years. Engineering drawings, consisting of engineering costs incurred to develop product plans, and software are amortized using the straight-line method over a period of three years.

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Impairment of non-financial assets

Property, plant and equipment and intangible assets are tested for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Long-lived assets that are not amortized are subject to an annual impairment test. For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units or CGUs). The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use (being the present value of the expected future cash flows of the relevant asset or CGU). An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount.

The Company evaluates impairment losses, other than goodwill impairment, for potential reversals when events or circumstances warrant such consideration.

Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Company's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in "intangible assets". Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to CGUs for the purpose of impairment testing. The allocation is made to those CGUs or groups of CGUs that are expected to benefit from the business combination in which the goodwill arose, identified according to operating segment.

Trade payables

Trade payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Accounts payable are classified as current liabilities if payment is due within one year or less (or in the normal operating cycle of the business if longer). If not, they are presented as non-current liabilities.

Trade payables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method.

Provisions

Provisions for restructuring costs, warranties and legal claims, where applicable, are recognized in accrued liabilities when the Company has a present legal or constructive obligation as a result of past events. It is more likely than not that an outflow of resources will be required to settle the obligation, and the amount can be reliably estimated. Provisions are measured at management's best estimate of the expenditure required to settle the obligation at the end of the reporting period, and are discounted to present value where the effect is material. The Company performs evaluations to identify onerous contracts and, where applicable, records provisions for such contracts.

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During the normal course of its operations, the Company assumes certain maintenance and repair costs under warranties offered on commercial equipment and biogas purification equipment. The warranties cover a period ranging from 12 to 18 months. A liability for the expected cost of the warranty-related claims is established when the product is delivered and completed. In estimating the warranty liability, historical material replacement costs and the associated labour costs are considered. Revisions are made when actual experience differs materially from historical experience.

Financial instruments

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership.

Financial assets and financial liabilities are offset and the net amount is reported in the statement of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the asset and settle the liability simultaneously. At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

Cash and cash equivalents	Loans and receivables
Trade and other receivables	Loans and receivables
Restricted cash	Loans and receivables
Loan to a joint venture	Loans and receivables
Bank overdraft	Other financial liabilities
Trade payables and accrued liabilities	Other financial liabilities
Derivative financial instruments	Fair value through profit or loss
Long-term debt	Other financial liabilities
Government royalty program obligation	Other financial liabilities
Subordinated loan	Other financial liabilities

A financial asset or financial liability is classified at fair value through profit and loss if acquired principally for the purpose of selling or repurchasing in the short term. Derivatives are also included in this category unless they are designated as hedges. Financial assets and financial liabilities classified as fair value through profit or loss are measured at fair value at each reporting period with changes in fair value in subsequent periods included in net loss. Transaction costs are expensed in the statement of income. Financial assets and financial liabilities at fair value through profit or loss are classified as current except for the portion expected to be realized or paid beyond 12 months of the statement of financial position date, which is classified as non-current.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are initially recognized at the amount expected to be received, less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment.

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

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(expressed in Canadian dollars)

Other financial liabilities are initially measured at fair value and subsequently at amortized cost using the effective interest method. Financial liabilities are classified as current liabilities if payment is due within 12 months. Otherwise, they are presented as non-current liabilities.

The Company classifies derivative financial instruments and embedded derivatives as fair value through profit and loss, and values them at fair value at the end of each period with changes recorded in other income. The Company does not designate these derivative financial instruments as hedges.

Impairment of financial assets

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired. If such evidence exists, the Company recognizes an impairment loss.

The loss on financial assets carried at amortized cost is the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent periods if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized. Impairment losses on available-for-sale equity instruments are not reversed.

Embedded derivatives

Derivatives may be embedded in other financial and non-financial instruments (the "host instrument"). Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host instrument, the terms of the embedded derivative are the same as those of a stand-alone derivative, and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with subsequent changes recognized in the consolidated statement of comprehensive income.

In the course of its operations, the Company enters into certain contracts for the sale of non-financial items that are denominated in currencies other than the Canadian dollar. In cases where the foreign exchange component is not leveraged and does not contain an option feature and the contract is denominated in the functional currency of the counterparty, the embedded derivative is considered to be closely related and is not accounted for separately. If the contract is neither in Canadian currency nor the functional currency of the counterparty, the embedded foreign currency derivative is separated unless the non-functional item delivered under the contract is routinely denominated in the currency of the contract in international commerce or the currency the contract is denominated in is commonly used in the economic environment in which the transaction takes place.

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Government royalty program obligations

The Company receives from time to time, from different government agencies, funding designed to promote economic growth, create jobs and wealth, and support sustainable development. In some of these arrangements, the Company has a contractual obligation to repay the contributions to the government agency, with repayments determined as a percentage of specified revenues over a contractually defined royalty period. Such arrangements are recognized as government royalty program obligations at initial recognition when the contribution is received. These obligations are estimated based on future projections, discounted using a rate that reflects the liability-specific risks. Over time, interest expense is recognized as a result of accretion of the long-term obligations, while royalty payments are recorded against the obligations. Subsequently, the government royalty program obligations are re-measured when the future projections initially used to measure the obligations are revised, using the original discount rate. Resulting changes in the carrying amount of these obligations are recognized in the consolidated statement of income as Finance costs.

Share capital

Common shares are classified as equity. Incremental costs directly attributable to the issuance of shares are recognized as a deduction from share capital.

Revenue recognition

The Company earns revenues mainly from the sale of natural gas dryers and hydrogen purification solutions (“commercial equipment”). The Company recognizes revenue on commercial equipment sales when it is probable that the economic benefits will flow to the Company and delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. These criteria are generally met at the time the product is shipped and delivered to the customer and, depending on the delivery conditions, title and risk have passed to the customer and acceptance of the product has been obtained. Provisions are established for estimated product returns and warranty costs at the time revenue is recognized. Cash received in advance of all of these revenue recognition criteria being met is recorded as deferred revenue.

Revenues from long-term production-type contracts such as biogas purification equipment and engineering service contracts are determined under the percentage-of-completion method whereby revenues are recognized based on the costs incurred to date in relation to the total expected costs of a contract (costs being composed mainly of materials). Costs and estimated profit on contracts in progress in excess of amounts billed are reflected as work in progress. Cash received in advance of revenues being recognized on contracts is recorded as deferred revenue.

The Company monitors its contracts with customers on a regular basis to determine if a loss is likely to occur. If a loss is anticipated on a contract, the entire estimated loss is recorded as a cost of sales in the year in which the loss becomes evident and reasonably estimable.

Revenue is measured based on the price specified in the sales contract, net of discounts and estimated returns at the time of sale. Historical experience is used to estimate and provide for discounts and returns. The Company does not have any multiple element revenue arrangements.

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Government assistance

Non-refundable grants relating to property, plant and equipment are accounted for as deferred government assistance and amortized on the same basis as the related assets.

Research and experimental development tax credits are recognized using the cost reduction method when there is reasonable assurance of their recovery. Investment tax credits are subject to the customary approvals by the pertinent tax authorities. Adjustments, if required, are reflected in the year when such assessments are received.

Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the statement of income on a straight-line basis over the period of the lease.

Lease agreements where the Company has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalized at the lease's commencement at the lower of the fair value of the leased property and the present value of the minimum lease payments.

Each lease payment is allocated between the liability and finance charges. The interest element of the finance cost is charged to the statement of income over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. Assets acquired under finance leases are depreciated over the shorter of the useful life of the asset and the lease term.

Stock-based compensation plans

The Company grants stock options to certain employees. Stock options vest over four years (25% per year) and expire after seven years from the date of grant. Each tranche in an award is considered a separate award with its own vesting period and grant date fair value. Fair value of each tranche is measured at the date of grant using the Black-Scholes option pricing model. The Black-Scholes model was developed to estimate the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, this model usually requires the input of assumptions, including expected stock price volatility. For options granted to directors, officers and employees of the Company, compensation expense is recognized over the tranche's vesting period by increasing contributed surplus based on the number of awards expected to vest. The number of awards expected to vest is reviewed at least annually. For options granted to non-employees, the transaction is measured with reference to the fair value of the goods or services when received. Related expense is recognized over the period in which the goods or services from the non-employees are received. A corresponding increase is recorded in contributed surplus when stock options are expensed. When stock options are exercised, capital stock is credited by the sum of the consideration paid and the related portion previously recorded in contributed surplus.

Research and development expenses

Research expenses are charged to expenses as incurred. Development expenses are charged to expenses as incurred unless they meet criteria for deferral and amortization. To date, no development expenses have been deferred.

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Income taxes

Income tax comprises current and deferred tax. Income tax is recognized in the statement of income except to the extent that it relates to items recognized directly in equity, in which case the income tax is also recognized directly in equity.

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

In general, deferred tax is recognized in respect of 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 on a non-discounted basis using tax rates and laws that have been enacted or substantively enacted at the statement of financial position date and are expected to apply when the deferred tax asset or liability is settled. Deferred tax assets are recognized to the extent that it is probable that the assets can be recovered.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are presented as non-current.

Tax on income in interim periods is accrued using the tax rate that would be applicable to expected total annual earnings.

Earnings per share

Basic earnings per share ("EPS") is calculated by dividing the net loss for the period attributable to equity owners of the Company by the weighted average number of common shares outstanding during the year.

Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The number of shares included with respect to options, warrants and similar instruments is computed using the treasury stock method, which assumes that if all dilutive securities had been exercised at the later of the beginning of the year and the date of issuance, as the case may be, the proceeds would be used to purchase common shares of the Company at the average market value during the year.

Foreign currency translation

a) Functional and presentation currency

Items included in the financial statements of each consolidated entity in the Company group are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The interim consolidated financial statements are presented in Canadian dollars, which is the Company's functional currency.

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The financial statements of entities that have a functional currency different from that of the Company (“foreign operations”) are translated into Canadian dollars as follows: assets and liabilities – at the closing rate at the date of the statement of financial position, and income and expenses – at the average rate of the period (as this is considered a reasonable approximation to actual rates). All resulting changes are recognized in other comprehensive income as cumulative translation adjustment.

When an entity disposes of its entire interest in a foreign operation, or loses control, joint control or significant influence over a foreign operation, the foreign currency gains or losses accumulated in other comprehensive income related to the foreign operation are recognized in profit or loss. If an entity disposes of part of an interest in a foreign operation which remains a subsidiary, a proportionate amount of foreign currency gains or losses accumulated in other comprehensive income related to the subsidiary is reallocated between controlling and non-controlling interests.

b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Generally, foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in currencies other than an operation’s functional currency are recognized in the statement of income.

Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the steering committee that makes strategic decisions.

Accounting standards issued but not yet applied

International Financial Reporting Standard 9, *Financial Instruments* (“IFRS 9”)

IFRS 9 was issued in November 2009 and contained requirements for financial assets. This standard addresses classification and measurement of financial assets and replaces the multiple category and measurement models in IAS 39, *Financial Instruments: Recognition and Measurement*, for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments, and such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where such equity instruments are measured at fair value through other comprehensive income, dividends, to the extent not clearly representing a return of investment, are recognized in profit or loss; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss would generally be recorded in other comprehensive income.

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IFRS 9 is required to be applied for accounting periods beginning on or after January 1, 2013, with earlier adoption permitted. The Company has not yet assessed the impact of the standard or determined whether it will adopt the standard early.

In May 2011, the IASB issued the following standards which have not yet been adopted by the Company: IFRS 10, *Consolidated Financial Statements*; IFRS 11, *Joint Arrangements*; IFRS 12, *Disclosure of Interests in Other Entities*; IAS 27, *Separate Financial Statements*; IFRS 13, *Fair Value Measurement*; and amended IAS 28, *Investments in Associates and Joint Ventures*. Each of the new standards is effective for annual periods beginning on or after January 1, 2013 with early adoption permitted. The Company has not yet begun the process of assessing the impact that the new and amended standards will have on its consolidated financial statements or whether to early adopt any of the new requirements.

The following is a brief summary of the new standards.

IFRS 10 – Consolidated Financial Statements

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12, *Consolidation – Special Purpose Entities*, and parts of IAS 27, *Consolidated and Separate Financial Statements*.

IFRS 11 – Joint Arrangements

IFRS 11 requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation, the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, *Interests in Joint Ventures*, and SIC-13, *Jointly Controlled Entities – Non-monetary Contributions by Venturers*.

IFRS 12 – Disclosure of Interests in Other Entities

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off-balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

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IFRS 13 – Fair Value Measurement

IFRS 13 is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that 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. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and in many cases does not reflect a clear measurement basis or consistent disclosures.

Amendments to other standards

In addition, there have been amendments to existing standards, including IAS 27, *Separate Financial Statements*, and IAS 28, *Investments in Associates and Joint Ventures*. IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13.

Significant accounting judgments and estimation uncertainties

Critical accounting estimates and judgments

The Company makes estimates and assumptions concerning the future that will, by definition, seldom equal actual results. The following are the estimates and judgments applied by management that most significantly affect the Company's consolidated financial statements. These estimates and judgments have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

c) Critical accounting estimates

i) Property, plant and equipment

Management estimates the useful lives of property, plant and equipment based on the period during which the assets are expected to be available for use. The amounts and timing of recorded expenses for depreciation of property, plant and equipment for any period are affected by these estimated useful lives. The estimates are reviewed at least annually and are updated if expectations change as a result of physical wear and tear, technical or commercial obsolescence, and legal or other limits to use. It is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's property, plant and equipment in the future.

ii) Goodwill

The Company tests annually whether goodwill has suffered any impairment. The recoverable amounts of CGUs have been determined based on value-in-use calculations. These calculations require the use of estimates.

No impairment charge was recorded during the period.

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- iii) Fair value of certain financial instruments, stock options, warrants and share awards

The fair value of financial instruments that are not traded in an active market (for example, stock options, warrants and share awards) is determined by using valuation techniques. The Company uses its judgment to select a variety of methods and make assumptions that are based mainly on market conditions existing at the end of each reporting period.

- iv) Inventory obsolescence

Inventories must be valued at the lower of cost or net realizable value. A writedown of the inventory will occur when its estimated market value less applicable variable selling expenses is below its carrying amount. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. This involves significant management judgment and is based on the Company's assessment of market conditions for its products determined by historical usage, estimated future demand and, in some cases, the specific risk of loss on specifically identified inventory. Any change in the assumptions used in assessing this valuation will impact the carrying amount of the inventory and have a corresponding impact on cost of sales.

- v) Impairment of long-lived assets

Long-lived assets or cash generating units are reviewed for impairment upon the occurrence of events or changes in circumstances indicating that the carrying value of the assets may not be recoverable, as measured by comparing their carrying amounts to the recoverable amount, which is the higher of fair value less cost to sell, and estimated discounted future cash flows generated by their use and eventual disposal. Impairment, if any, is measured as the excess of the carrying amount of the asset or cash generating unit over its recoverable amount.

- vi) Recognition of future income tax assets

A deferred tax asset shall be recognized for all deductible temporary differences and unused tax losses to the extent that it is probable that taxable profit will be available against which the deductible temporary difference and unused tax losses can be utilized. Therefore, the Company has to estimate the amount of future taxable profits expected to be available. Such estimates are made by tax jurisdiction on an undiscounted basis. Management exercises judgment to determine the extent to which realization of future taxable benefits is probable, considering factors such as the number of years to include in the forecast period and the history of taxable profits.

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vii) Government royalty program obligations

Government royalty program obligations are recognized when the contributions, which can come from different government agencies, are received and the company has a contractual obligation to repay the contributions (refer to note 4 (iv) (e)) for a description of the programs). As repayments are determined based on a percentage of specified revenues over a contractually defined royalty period, these obligations are measured as the net present value of expected future royalties payable. The key assumptions used in the valuation of these obligations are the projected annual revenues and the discount rate amounting to 30%. Subsequent to initial recognition, the government royalty program obligations are re-measured when the projections of expected future royalties payable initially used to measure the obligations are revised, using the original discount rate.

4 Transition to IFRS

The effect of the Company's transition to IFRS, described in note 2, is summarized in this note as follows:

- i) Transition elections
- ii) Reconciliation of equity and comprehensive income as previously reported under Canadian GAAP to IFRS
- iii) Adjustments to the statement of cash flows
- iv) Additional IFRS information for the year ended December 31, 2010

i) Transition elections

The Company has applied the following transition exemptions to full retrospective application of IFRS:

	As described in note 4(ii)
Borrowing costs	(a)
Cumulative translation adjustment	(b)
Business combinations	(c)
Leases	(d)
Compound financial instruments	(e)

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ii) Reconciliation of shareholders' equity and comprehensive loss as previously reported under Canadian GAAP to IFRS

Note 4(ii)	December 31, 2010			March 31, 2010			January 1, 2010		
	Canadian GAAP \$	Adjustment \$	IFRS \$	Canadian GAAP \$	Adjustment \$	IFRS \$	Canadian GAAP \$	Adjustment \$	IFRS \$
Assets									
Current assets									
Cash and cash equivalents	2,262,273	-	2,262,273	5,132,067	-	5,132,067	5,447,702	-	5,447,702
Trade and other receivables	2,603,261	-	2,603,261	1,829,009	-	1,829,009	3,105,834	-	3,105,834
Inventories	2,720,060	-	2,720,060	3,053,646	-	3,053,646	2,867,922	-	2,867,922
Income taxes recoverable	-	-	-	29,855	-	29,855	62,492	-	62,492
Investment tax credits receivable	103,489	-	103,489	65,217	-	65,217	80,843	-	80,843
Restricted cash	576,092	-	576,092	206,997	-	206,997	223,261	-	223,261
Other current assets	100,846	-	100,846	192,637	-	192,637	183,564	-	183,564
Total current assets	8,366,021	-	8,366,021	10,509,428	-	10,509,428	11,971,618	-	11,971,618
Non-current assets									
Loan to a joint venture	117,811	-	117,811	110,353	-	110,353	113,331	-	113,331
Property, plant and equipment	(g) 1,939,097	(30,655)	1,908,442	2,413,471	(57,657)	2,355,814	2,604,931	(59,142)	2,545,789
Intangible assets	(f)(i), (f)(iii), (g)	461,075	4,483,897	263,094	4,819,937	5,083,031	279,046	4,943,751	5,222,797
Goodwill	(f)(i), (f)(ii)	(1,095,708)	342,616	5,951,390	(5,608,774)	342,616	5,942,152	(5,599,536)	342,616
Total non-current assets	7,518,054	(665,288)	6,852,766	8,738,308	(846,494)	7,891,814	8,939,460	(714,927)	8,224,533
Total assets	15,884,075	(665,288)	15,218,787	19,247,736	(846,494)	18,401,242	20,911,078	(714,927)	20,196,151
Liabilities									
Current liabilities									
Bank overdraft	500,000	-	500,000	487,692	-	487,692	496,900	-	496,900
Trade payables and accrued liabilities	(f)(i), (f)(iii), (h)	(1,504,992)	7,089,760	4,984,690	(676,392)	4,308,298	5,578,505	(992,302)	4,586,203
Deferred revenues	2,331,802	-	2,331,802	2,170,920	-	2,170,920	146,228	-	146,228
Income taxes payable	8,286	-	8,286	-	-	-	-	-	-
Derivative financial instruments	-	-	-	172,963	-	172,963	96,645	-	96,645
Current portion of long-term debt	87,151	-	87,151	321,653	-	321,653	321,653	-	321,653
Current portion of subordinated loan	156,256	-	156,256	62,496	-	62,496	62,496	-	62,496
Provisions	(h)	1,036,095	1,036,095	-	-	-	-	141,309	141,309
Total current liabilities	11,678,247	(468,897)	11,209,350	8,200,414	(676,392)	7,524,022	6,702,427	(850,993)	5,851,434
Non-current liabilities									
Long-term debt	1,867,870	-	1,867,870	1,791,654	-	1,791,654	1,763,496	-	1,763,496
Government royalty program obligation	(f)(iii), (f)(iv)	691,539	691,539	-	1,181,117	1,181,117	-	1,137,307	1,137,307
Government assistance	32,083	-	32,083	35,833	-	35,833	37,083	-	37,083
Provisions	(h)	304,034	304,034	-	511,009	511,009	-	694,674	694,674
Subordinated loan	-	-	-	140,632	-	140,632	156,256	-	156,256
Total non-current liabilities	1,899,953	995,573	2,895,526	1,968,119	1,692,126	3,660,245	1,956,835	1,831,981	3,788,816
Total liabilities	13,578,200	526,676	14,104,876	10,168,533	1,015,734	11,184,267	8,659,262	980,988	9,640,250
Shareholders' Equity									
Share capital	19,964,218	-	19,964,218	18,107,821	-	18,107,821	18,107,821	-	18,107,821
Contributed surplus	1,841,741	-	1,841,741	57,966	-	57,966	51,368	-	51,368
Accumulated other comprehensive loss	(b), (g)	72,622	72,622	-	21,898	21,898	-	-	-
Deficit	(b), (f)(i), (f)(ii), (f)(iii), (f)(iv), (g)	(1,264,586)	(20,764,670)	(9,086,584)	(1,884,126)	(10,970,710)	(5,907,373)	(1,695,915)	7,603,288
Total shareholders' equity	2,305,875	(1,191,964)	1,113,911	9,079,203	(1,862,228)	7,216,975	12,251,816	(1,695,915)	10,555,901
Total liabilities and shareholders' equity	15,884,075	(665,288)	15,218,787	19,247,736	(846,494)	18,401,242	20,911,078	(714,927)	20,196,151

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	Note 4 (ii)	For the year ended December 31, 2010			For the three-month period ended March 31, 2010		
		Canadian GAAP \$	Adjustment \$	IFRS \$	Canadian GAAP \$	Adjustment \$	IFRS \$
Revenue		13,475,211	-	13,475,211	1,991,650	-	1,991,650
Cost of goods sold	(f)(i), (f)(iii), (g), (j)	13,226,426	367,742	13,594,168	1,670,043	203,310	1,873,353
Gross margin		248,785	(367,742)	(118,957)	321,607	(203,310)	118,297
Research and development expenses		2,550,638	-	2,550,638	542,892	-	542,892
Selling and administrative expenses	(f)(i), (j)	10,132,192	492,434	10,624,626	2,487,171	123,108	2,610,279
Financial	(i)	443,042	(443,042)	-	91,110	(91,110)	-
Foreign exchange loss (gain)	(g)	(206,710)	75,903	(130,807)	164,935	32,519	197,454
Depreciation and amortization	(j)	922,334	(922,334)	-	214,710	(214,710)	-
		13,841,496	(797,039)	13,044,457	3,500,818	(150,193)	3,350,625
Finance income	(f)(iii), (f)(iv), (i)	-	(659,558)	(659,558)	-	(6,900)	(6,900)
Finance expenses	(f)(iii), (i)	-	657,526	657,526	-	141,994	141,994
Finance costs – net		-	(2,032)	(2,032)	-	135,094	135,094
Loss before income taxes		(13,592,711)	431,329	(13,161,382)	(3,179,211)	(188,211)	(3,367,422)
Income taxes		-	-	-	-	-	-
Net loss for the period		(13,592,711)	431,329	(13,161,382)	(3,179,211)	(188,211)	(3,367,422)
Other comprehensive income (net of tax)							
Cumulative translation adjustment	(b), (g)	-	72,622	72,622	-	21,898	21,898
Other comprehensive income for the period		-	72,622	72,622	-	21,898	21,898
Comprehensive income (loss) for the period		(13,592,711)	503,951	(13,088,760)	(3,179,211)	(166,313)	(3,345,524)

Explanatory notes

- In accordance with IFRS transitional provisions, the Company elected to apply IFRS relating to borrowing costs prospectively from January 1, 2010. As such, Canadian GAAP balances relating to borrowing costs entered into before that date have been carried forward without adjustment.
- In accordance with IFRS transitional provisions, the Company has elected to reset the cumulative translation adjustment account, which includes gains and losses arising from the translation of foreign operations, to zero at the date of transition to IFRS. Refer to note g) below for details.
- In accordance with IFRS transitional provisions, the Company has elected to apply IFRS 3, *Business Combinations* prospectively from June 12, 2009. As such, Canadian GAAP balances relating to business combinations entered into before that date, including goodwill, have been carried forward without adjustment, and the reverse takeover transaction with QuestAir, which occurred on June 12, 2009, was adjusted to meet IFRS requirements. Refer to note f) below.

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- d) In accordance with IFRS transitional provisions, the Company has elected to apply IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, based on the circumstances existing at the date of transition to IFRS, to all arrangements other than those entered into or modified since January 1, 2005, as such arrangements have already been assessed under requirements similar to those of IFRIC 4. No impact resulted from the review of arrangements.
- e) In accordance with IFRS transitional provisions, the Company has elected not to apply retrospectively the requirement to separate liability and equity components of compound financial instruments to instruments for which the liability component was no longer outstanding on the transition date.
- f) As at December 31, 2009, formal valuation of the tangible and intangible assets acquired and liabilities assumed through the QuestAir acquisition was not completed. Accordingly, the excess of the purchase price over the net book value of identifiable assets acquired was, at that time, preliminarily allocated to goodwill on the Canadian GAAP consolidated balance sheet. During the second quarter of 2010, the Company finalized the purchase price allocation pertaining to this acquisition.

IFRS 3 requirements were applied to the QuestAir acquisition. As a result, the final fair values established in 2010 were used in accounting for that transaction when establishing the IFRS opening statement of financial position as at January 1, 2010 as, per IFRS 3, adjustments to preliminary or provisional estimates are required to be treated retrospectively as if the adjustment had been determined at the acquisition date.

- i) As at June 12, 2009, the acquisition date, the IFRS consolidated statement of financial position was adjusted to reflect the final allocation resulting in increases in accounts receivable of \$466,699, in contract asset of \$330,886, in customer relations of \$1,900,000, in patents of \$2,310,000, and in accounts payable and accrued liabilities of \$9,238, and decreases in inventories and deferred revenue of \$1,724,201 and \$1,229,682 respectively. Consistent with these changes, goodwill has decreased by \$4,503,828.
- ii) As per IFRS 3, transaction costs are required to be expensed as incurred. Consequently, goodwill further decreased by \$1,095,708 with a corresponding entry in the retained earnings.
- iii) Prior to the acquisition date, QuestAir received, from a number of government agencies, such as Technology Partnerships Canada ("TPC"), funding designed to promote economic growth, create jobs and wealth, and support sustainable development. Funding was in the form of contributions determined as (a) a percentage of defined eligible costs; or (b) a maximum amount as specified in the government support agreement. In some of these arrangements, the Company has a contractual obligation to repay the contributions to the government agency, with repayments determined as a percentage of specified revenues over a contractually defined royalty period (refer to note 4(iv)(e)) below for a description of the programs).

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Under Canadian GAAP, the Company records government contributions as a reduction of the related R&D program costs or as a reduction in the program's capitalized expenditures. A liability to repay the government contribution is recognized when conditions arise and the repayment thereof is reflected in the consolidated statement of comprehensive income when royalties become due. Under IFRS, such arrangements in which Xebec entered into do not qualify as government grants and should therefore be recognized as liabilities at initial recognition as they fall under the scope of IAS 39. Consequently, repayable government assistance arrangements are recognized as Government royalty program obligations when the contribution is received and is estimated based on future projections. Therefore, as at June 12, 2009, the acquisition date, the IFRS consolidated statement of financial position was adjusted to reflect the recognition of government royalty program obligations amounting to \$989,013, with a corresponding entry to intangible assets. The obligations were measured based on projected revenues and corresponding royalty payments expected at the transaction date, using a discount rate of 30%. Following this change in accounting treatment, interest expense is recognized as a result of accretion of the long-term obligations, while royalty payments are recorded against the obligations instead of as an expense as under Canadian GAAP.

- iv) In accordance with IAS 39, the government royalty program obligations are re-measured when the future projections used to measure the obligations are revised. Resulting changes in the carrying amount of these obligations are recognized in the consolidated statement of comprehensive income. Accordingly, as at December 31, 2010, the IFRS consolidated statement of financial position was adjusted to reflect the change in carrying value of government royalty program obligations amounting to \$641,729 with a corresponding entry to finance income. The obligations were measured based on projected revenues and corresponding royalty payments expected at that date, using the original discount rate of 30%.

Total government royalty program obligations can be broken down as follows:

	December 31, 2010	March 31, 2010	January 1, 2010
	\$	\$	\$
Fast Cycle Pressure Swing Adsorption and Gas Management systems	579,278	1,092,693	1,055,110
Pulsar Pressure Swing adsorption project	112,261	88,424	82,197
	<u>691,539</u>	<u>1,181,117</u>	<u>1,137,307</u>

Refer to the tables below for the details of the impacts, resulting from the above described changes, on the IFRS opening consolidated statement of financial position and subsequent period presented.

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- g) Items included in the financial statements of the Company's subsidiaries and joint ventures must be measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). Under IFRS, indicators to consider for determining the functional currency of an entity are broken down into primary and secondary indicators. Under Canadian GAAP, there is no such hierarchy when assessing the factors for determining the measurement currency.

Following the assessment of these indicators using the IFRS hierarchy, management concluded that the Company's subsidiary (Xebec Adsorption (Shanghai) Co. Ltd.) and joint venture (Xebec Adsorption South East Asia PTE. Ltd) should use the Chinese renminbi (yuan) and the Singapore dollar respectively as their functional currency to meet IFRS requirements as opposed to the Canadian dollar measurement currency used under Canadian GAAP. Accordingly, the Company has prepared an opening statement of financial position for these entities, as at January 1, 2010, using their respective functional currencies as if they had always been used.

As the functional currency of the subsidiary and joint venture differs from that of the Company, the financial statements of these entities were translated, for consolidation purposes, into Canadian dollars as follows: assets and liabilities at the closing rate at the date of the statement of financial position, and income and expenses at the average rate of the period. All resulting changes were recognized in other comprehensive income as cumulative translation adjustment. However, as the Company elected, in accordance with IFRS transitional provisions, to reset the cumulative translation adjustment account to zero at the date of transition to IFRS (refer to note b) above), amounts that would have been recognized in the cumulative translation adjustment account prior to January 1, 2010 have been transferred to retained earnings at that date.

Refer to the tables below for the details of the impacts, resulting from the above described changes, on the opening IFRS consolidated statement of financial position and subsequent period presented.

- h) Under IFRS, warranty and other provisions, which were classified as accounts payable and accrued liabilities in Canadian GAAP consolidated financial statements have been reclassified as provisions as required by IAS 1, *Presentation of Financial Statements*. The reclassification on January 1, 2010, March 31, 2010 and December 31, 2010 amounts to \$835,983, \$511,009 and \$1,340,129 respectively.
- i) Under IFRS, finance income and finance expense are presented separately in the consolidated statement of income. Under Canadian GAAP, net interest expense was presented in the consolidated statement of income. Accordingly, finance income balances for the periods ended March 31, 2010 and December 31, 2010 have been reclassified in finance income (\$6,900 and \$17,829 respectively).
- j) Under IFRS, expenses recognized in the statement of comprehensive income must be presented using a classification based on nature or function. The Company chose to use a presentation by function. Accordingly, amortization expense for the periods ended March 31, 2010 and December 31, 2010 have been reclassified in cost of goods sold (\$159,459 and \$565,615 respectively) and selling and administrative expenses (\$55,251 and \$356,719 respectively).

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements (Unaudited)

March 31, 2011

(expressed in Canadian dollars)

Statement of financial position

	As at January 1, 2010					
	Canadian GAAP	Note 4(ii)			IFRS	
	\$	(f)(i), (f)(ii) \$	(f)(iii) \$	(b), (g) \$	(h) \$	\$
Non-current assets						
Property, plant and equipment	2,604,931	-	-	(59,142)	-	2,545,789
Intangible assets	279,046	3,997,286	956,046	(9,581)	-	5,222,797
Goodwill	5,942,152	(5,599,536)	-	-	-	342,616
Current liabilities						
Trade payables and accrued liabilities	5,578,505	9,238	(165,557)	-	(835,983)	4,586,203
Provision	-	-	-	-	141,309	141,309
Non-current liabilities						
Government royalty program obligation	-	-	1,137,307	-	-	1,137,307
Provision	-	-	-	-	694,674	694,674
Shareholders' Equity						
Accumulated other comprehensive income	-	-	-	-	-	-
Retained earnings (deficit) –						
Beginning of period	825,041	(1,611,488)	(15,704)	-	-	(802,151)
Net loss for the period	(6,732,414)	-	-	(68,723)	-	(6,801,137)
Total Equity	12,251,816	(1,611,488)	(15,704)	(68,723)	-	10,555,901

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements (Unaudited)

March 31, 2011

(expressed in Canadian dollars)

Statement of financial position

	As at March 31, 2010					
	Canadian GAAP	Note 4(ii)			IFRS	
	\$	(f)(i), (f)(ii) \$	(f)(iii) \$	(b), (g) \$	(h), (i), (j) \$	\$
Non-current assets						
Property, plant and equipment	2,413,471	-	-	(57,657)	-	2,355,814
Intangible assets	263,094	3,890,929	939,562	(10,554)	-	5,083,031
Goodwill	5,951,390	(5,599,536)	-	-	(9,238)	342,616
Current liabilities						
Trade payables and accrued liabilities	4,984,690	9,238	(165,383)	-	(520,247)	4,308,298
Non-current liabilities						
Government royalty program obligation	-	-	1,181,117	-	-	1,181,117
Provision	-	-	-	-	511,009	511,009
Shareholders' Equity						
Accumulated other comprehensive income	-	-	-	(10,621)	32,519	21,898
Deficit – Beginning of period	(5,907,373)	(1,611,488)	(15,704)	(68,723)	-	(7,603,288)
Net loss for the period	(3,179,211)	(106,357)	(60,468)	11,133	(32,519)	(3,367,422)
Total Equity	9,079,203	(1,717,845)	(76,172)	(68,211)	-	7,216,975

Statements of loss and comprehensive loss

	For the three-month period ended March 31, 2010					
	Canadian GAAP	Note 4(ii)			IFRS	
	\$	(f)(i), (f)(ii) \$	(f)(iii) \$	(b), (g) \$	(h), (i), (j) \$	\$
Cost of goods sold	1,670,043	38,500	16,484	(11,133)	159,459	1,873,353
Selling and administrative expenses	2,487,171	67,857	-	-	55,251	2,610,279
Financial	91,110	-	-	-	(91,110)	-
Foreign exchange loss	164,935	-	-	-	32,519	197,454
Amortization	214,710	-	-	-	(214,710)	-
Finance income	-	-	-	-	(6,900)	(6,900)
Finance expenses	-	-	43,984	-	98,010	141,994
Net loss for the period	(3,179,211)	(106,357)	(60,468)	11,133	(32,519)	(3,367,422)
Cumulative translation adjustment	-	-	-	(10,621)	32,519	21,898
Comprehensive loss	(3,179,211)	(106,357)	(60,468)	512	-	(3,345,524)

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements (Unaudited)

March 31, 2011

(expressed in Canadian dollars)

Statement of financial position

	As at December 31, 2010					
	Canadian GAAP	Note 4(ii)			IFRS	
	\$	(f)(i), (f)(ii) \$	(f)(iii) \$	(b), (g) \$	(h), (i), (j) \$	\$
Non-current assets						
Property, plant and equipment	1,939,097	-	-	(30,655)	-	1,908,442
Intangible assets	4,022,822	(425,429)	890,112	(3,608)	-	4,483,897
Goodwill	1,438,324	(1,095,708)	-	-	-	342,616
Current liabilities						
Trade payables and accrued liabilities	8,594,752	-	(164,863)	-	(1,340,129)	7,089,760
Provision	-	-	-	-	1,036,095	1,036,095
Non-current liabilities						
Government royalty program obligation	-	-	691,539	-	-	691,539
Provision	-	-	-	-	304,034	304,034
Shareholders' Equity						
Accumulated other comprehensive income	-	-	-	(3,281)	75,903	72,622
Deficit – Beginning of year	(5,907,373)	(1,611,488)	(15,704)	(68,723)	-	(7,603,288)
Net loss for the year	(13,592,711)	90,351	379,140	37,741	(75,903)	(13,161,382)
Total Equity	2,305,875	(1,521,137)	363,436	(34,263)	-	1,113,911

Statements of loss and comprehensive loss

	For the year ended December 31, 2010					
	Canadian GAAP	Note 4(ii)			IFRS	
	\$	(f)(i), (f)(ii) \$	(f)(iii) \$	(b), (g) \$	(h), (i), (j) \$	\$
Cost of goods sold	13,226,426	(226,066)	65,934	(37,741)	565,615	13,594,168
Selling and administrative expenses	10,132,192	135,715	-	-	356,719	10,624,626
Financial	443,042	-	-	-	(443,042)	-
Foreign exchange gain	(206,710)	-	-	-	75,903	(130,807)
Amortization	922,334	-	-	-	(922,334)	-
Finance income	-	-	(641,729)	-	(17,829)	(659,558)
Finance expenses	-	-	196,655	-	460,871	657,526
Net loss for the year	(13,592,711)	90,351	379,140	37,741	(75,903)	(13,161,382)
Cumulative translation adjustment	-	-	-	(3,281)	75,903	72,622
Comprehensive loss	(13,592,711)	90,351	379,140	34,460	-	(13,088,760)

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

iii) Adjustments to the statement of cash flows

The transition from Canadian GAAP to IFRS had no significant impact on cash flows generated by the Company.

iv) Additional IFRS information for the year ended December 31, 2010

a) Investment in joint venture

The following summarizes financial information about the Company's 40% share of the assets, liabilities, revenue and profit or loss of its unlisted joint venture, Xebec Adsorption South East Asia PTE. Ltd., for the year ended December 31, 2010.

	\$
Assets	192,286
Liabilities	174,548
Revenues	437,904
Loss	(114,093)
Comprehensive loss	(117,965)
Proportionate interest in joint venture's commitments	27,473

In addition, there is a loan to the joint venture bearing interest of 7.93%, repayable by minimum annual instalments of \$37,777 plus accrued and unpaid interest, and maturing in July 2012. An agreement was concluded giving a one-year moratorium on repayment of the loan, including interest.

There are no contingent liabilities relating to the Company's interest in the joint venture, and no contingent liabilities of the joint venture itself.

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

b) Property, plant and equipment

	Land \$	Building \$	Machinery and equipment \$	Office furniture and equipment \$	Computers \$	Moulds \$	Vehicles \$	Leasehold improvements \$	Total \$
As at January 1, 2010									
Cost	173,180	981,353	796,252	106,417	309,667	192,745	-	648,731	3,208,345
Accumulated depreciation	-	(126,436)	(139,344)	(23,097)	(146,829)	(33,879)	-	(192,971)	(662,556)
Net book value	173,180	854,917	656,908	83,320	162,838	158,866	-	455,760	2,545,789
Year ended December 31, 2010									
Opening net book value	173,180	854,917	656,908	83,320	162,838	158,866	-	455,760	2,545,789
Additions	-	-	-	464	11,058	11,121	71,968	-	94,611
Disposals	-	-	(2,550)	-	-	-	-	-	(2,550)
Depreciation for the period	-	(49,067)	(186,175)	(25,384)	(115,301)	(12,833)	(7,197)	(212,810)	(608,767)
Exchange differences	-	-	(1,035)	(120)	(461)	(625)	-	(614)	(2,855)
Impairment	-	-	-	-	-	(117,786)	-	-	(117,786)
Closing net book value	173,180	805,850	467,148	58,280	58,134	38,743	64,771	242,336	1,908,442
As at December 31, 2010									
Cost	173,180	981,353	791,817	106,598	319,628	62,527	71,968	645,330	3,152,401
Accumulated depreciation	-	(175,503)	(324,669)	(48,318)	(261,494)	(23,784)	(7,197)	(402,994)	(1,243,959)
Net book value	173,180	805,850	467,148	58,280	58,134	38,743	64,771	242,336	1,908,442

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

c) Intangible assets

	Patents \$	Customer relations \$	Other Software \$	Internally generated Engineering drawings \$	Total \$
As at January 1, 2010					
Cost	3,299,013	1,900,000	393,906	4,700	5,597,619
Accumulated amortization	(109,967)	(135,714)	(127,574)	(1,567)	(374,822)
Net book value	<u>3,189,046</u>	<u>1,764,286</u>	<u>266,332</u>	<u>3,133</u>	<u>5,222,797</u>
Year ended December 31, 2010					
Opening net book value	3,189,046	1,764,286	266,332	3,133	5,222,797
Additions	-	-	-	-	-
Amortization for the year	(219,934)	(271,429)	(61,546)	(1,566)	(554,475)
Impairment	-	-	(184,000)	-	(184,000)
Exchange differences	-	-	(425)	-	(425)
Closing net book value	<u>2,969,112</u>	<u>1,492,857</u>	<u>20,361</u>	<u>1,567</u>	<u>4,483,897</u>
As at December 31, 2010					
Cost	3,299,013	1,900,000	392,700	4,700	5,596,413
Accumulated amortization	(329,902)	(407,143)	(372,339)	(3,133)	(1,112,516)
Net book value	<u>2,969,111</u>	<u>1,492,857</u>	<u>20,361</u>	<u>1,567</u>	<u>4,483,897</u>

d) Provisions

	Severance \$	Warranty \$	Halla Project \$	UK Provision \$	Total \$
As at January 1, 2010	141,309	694,674	-	-	835,983
Additional provisions	225,058	66,234	759,518	51,519	1,102,329
Unused amounts reversed	(64,000)	(272,150)	-	-	(336,150)
Used during the period	(77,309)	(184,724)	-	-	(262,033)
Exchange differences	-	-	-	-	-
As at December 31, 2010	<u>225,058</u>	<u>304,034</u>	<u>759,518</u>	<u>51,519</u>	<u>1,340,129</u>
Less: Current portion	225,058	-	759,518	51,519	1,036,095
	<u>-</u>	<u>304,034</u>	<u>-</u>	<u>-</u>	<u>304,034</u>

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

e) Government royalty program obligations

The Company receives from time to time, from different government agencies, funding designed to promote economic growth, create jobs and wealth, and support sustainable development. In some of these arrangements, the Company has a contractual obligation to repay the contributions to the government agency, with repayments determined as a percentage of specified revenues over a contractually defined royalty period. When such arrangements are concluded, government royalty program obligations are recognized when the contributions are received. Arrangements that Xebec entered into are described below:

Technologies Partnership Canada (“TPC”) Program

a) Fast Cycle Pressure Swing Adsorption and Gas Management systems

Upon the reverse takeover of QuestAir, the Company assumed the June 6, 2003 agreement with Industry Canada under the TPC Program to receive financial contributions regarding the development and commercial exploitation of its Fast Cycle Pressure Swing Adsorption (“FCPSA”) and Gas Management systems (“GMS”). The agreement had been amended in 2008.

Pursuant to the agreement, total project costs for the period from October 1, 2002 to September 30, 2008 were to be shared, subject to certain contribution limits, such that the Department’s contribution would not exceed the lesser of 30% of eligible project costs and \$8,139,937.

The agreement further provides that the Department shall provide the Company with financial contributions based on the aforementioned limitations in exchange for:

- the issuance of 19,230 transferable warrants convertible into common shares at a strike price of \$38.80, exercisable for a term of five years (which warrants expired unexercised); and
- repayable contributions to the Department during the royalty period, which ends on September 20, 2022, based on 1.165% (0.471% from October 1, 2009 thereafter) of gross business revenues.

Cumulative repayments of \$963,802 have been made up to December 31, 2010 (2009 – \$797,967).

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements

(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

b) Pulsar Pressure Swing Adsorption project

The Company assumed the March 31, 1999 agreement with Industry Canada under the TPC Program to receive financial contributions regarding the development and commercial exploitation of QuestAir's Pulsar Pressure Swing Adsorption project.

Pursuant to the agreement, total project costs for the period from October 1, 1998 to March 31, 2002 were to be shared, subject to annual contribution limits, such that the Department's contribution would not exceed the lesser of 35% of eligible project costs and \$4,947,330.

QuestAir had received contributions aggregating \$4,762,503. The agreement further provides that the contributions are repayable solely based on a royalty of 1.8% of gross project revenues and revenues from fuel cell-related products to a maximum cumulative repayment of \$8,750,000. Cumulative repayments of \$56,736 have been made up to December 31, 2010 (2009 – \$56,736). The agreement terminates on the later of the date of payment of all amounts due to the Department and 2015.

Natural Resources Canada Agreement

c) Structured adsorbent

In January 2005, QuestAir received a grant of \$225,000 from the Government of Canada under the Department of Natural Resources Efficiency and Alternative Energy Program to support the development of structured adsorbent that will possess enhanced properties to assist in high purity hydrogen separation. The agreement provides that such contributions are repayable solely based on 0.12% of gross project revenues through March 31, 2015 to a maximum cumulative repayment of \$225,000, whichever occurs first. Cumulative repayments of \$5,592 have been made up to December 31, 2010 (2009 – \$5,592). As the program was abandoned prior to January 1, 2010, no obligation was recorded with respect to that arrangement.

d) Efficiency of High Temperature Fuel Cell system and co-production of hydrogen

In January 2004, QuestAir received a grant of \$193,944 from the Government of Canada under the Department of Natural Resources Efficiency and Alternative Energy Program to support the development of a device that increases the efficiency of a High Temperature Fuel Cell system and permits the co-production of hydrogen. The agreement provides that such contributions are repayable solely based on 0.12% of gross project revenues through March 31, 2014 to a maximum cumulative repayment of \$193,944, whichever occurs first. To date, no such project revenue has been recorded. As the program was abandoned prior to January 1, 2010, no obligation was recorded with respect to that arrangement.

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements (Unaudited)

March 31, 2011

(expressed in Canadian dollars)

Total government royalty program obligations can be broken down as follows:

	December 31, 2010	January 1, 2011
	\$	\$
Fast Cycle Pressure Swing Adsorption and Gas Management systems	579,278	1,055,110
Pulsar Pressure Swing adsorption project	112,261	82,191
	<u>691,539</u>	<u>1,137,301</u>

f) Loss per share

i) Basic

Basic loss per share is calculated by dividing the net income attributable to owners of the parent by the weighted average number of ordinary shares in issue during the year.

	For the year ended December 31, 2010
	\$
Net loss attributable to owners of the parent	(13,161,382)
Weighted average number of ordinary shares in issue	<u>30,803,752</u>
	<u>(\$0.43)</u>

ii) Diluted

Diluted loss per share is calculated by adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares. The Company has two categories of dilutive potential ordinary shares: warrants and stock options. For both, a calculation is performed to determine the number of shares that could have been acquired at fair value (determined as the average market share price of the Company's outstanding shares for the period), based on the monetary value of the subscription rights attached to the warrants and stock options. The number of shares calculated above is compared with the number of shares that would have been issued assuming exercise of the warrants and stock options. Outstanding share options and warrants to purchase common shares were not included in the computation of diluted loss per share as they do not have any dilutive impact.

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

g) Expense by nature

	For the year ended December 31, 2010 \$
Employee benefits	9,501,660
Material	7,341,912
Subcontract costs	1,625,384
Freight	421,998
Audit and legal fees	1,256,204
Travel expenses	768,560
Consulting	801,748
Rent	413,568
Financial expenses	(2,032)
Amortization	1,163,242
Foreign exchange loss	(130,807)
Other	3,475,156
	<u>26,636,593</u>

h) Employee benefits

	For the year ended December 31, 2010 \$
Salaries and wages	9,418,806
Termination benefits	82,854
	<u>9,501,660</u>

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements
(Unaudited)

March 31, 2011

(expressed in Canadian dollars)

i) Compensation of key management

Compensation awarded to key management included:

	For the year ended December 31, 2010 \$
Salaries and short-term employee benefits	1,372,360
Termination benefits	51,923
	<u>1,424,283</u>

j) Construction contracts

	December 31, 2010 \$
Contract revenue recognized as revenue in the period	3,189,248
Contract costs incurred and recognized profits (less recognized losses)	3,948,766
Advances received	3,167,082
Gross amount due from customer for contract work – Presented as an asset	112,394
Gross amount due to customers for contract work – Presented as a liability	89,286

5 Segmented information

The Company has only one segment and specializes in the design and manufacture of filtration, purification, separation and dehydration equipment for gases and compressed air. The Company has five product lines and provides related engineering services.

Xebec Adsorption Inc.

Notes to Condensed Interim Consolidated Financial Statements (Unaudited)

March 31, 2011

(expressed in Canadian dollars)

Revenue summarized by region, as determined by location of the customers, is as follows:

	2011	2010
	\$	\$
North America	3,488,115	1,094,319
Asia	333,900	542,032
Europe	227,403	259,005
Others	2,113	96,294
	<u>4,051,531</u>	<u>1,991,650</u>

Revenue summarized by product line is as follows:

	2011	2010
	\$	\$
Licencing	1,464,887	-
Gas purification	1,101,000	313,475
Engineering services	642,111	105,250
Natural gas dryers	320,294	478,034
Compressed gas filtration	422,871	971,746
Air dryers	100,368	123,145
	<u>4,051,531</u>	<u>1,991,650</u>

Major customers representing 10% or more of total sales include:

	2011	2010
	\$	\$
Customer A	1,464,887	-
Customer B	642,111	-
Customer C	-	238,112
	<u>2,106,998</u>	<u>238,112</u>

The location of the Company's assets by geographic region is as follows:

	March 31,	December 31,	January 1,
	2011	2010	2010
	\$	\$	\$
Canada	12,182,855	13,229,927	17,020,565
Asia	1,671,498	1,988,860	3,175,586
	<u>13,854,353</u>	<u>15,218,787</u>	<u>20,196,151</u>