



Xebec Adsorption Inc.

**Management Discussion and Analysis
For the year-ended December 31, 2009**

March 29, 2010

Additional information relating to the Company can be found on SEDAR at www.sedar.com.

ABOUT XEBEC ADSORPTION INC.

Xebec Adsorption Inc. (“Xebec” or “the company”) is a global provider of clean energy solutions to corporations and governments looking to reduce their carbon footprints. With more than 1300 customers worldwide, Xebec designs, engineers and manufactures innovative products that transform raw gases into marketable sources of clean energy. Xebec’s strategy is focused on establishing leadership positions in markets where demand for biogas upgrading, natural gas dehydration and hydrogen purification is growing. Headquartered in Montreal (QC), Xebec is a global company with two state-of-the-art manufacturing facilities in Montreal and Shanghai, R&D facilities in Vancouver (BC) as well as a sales and distribution network in North America, Asia and Europe. Xebec (www.xebecinc.com) trades on the Toronto Stock Exchange (“TSX”) under the symbol XBC.

ABOUT THIS MANAGEMENT DISCUSSION AND ANALYSIS

This Management Discussion and Analysis (“MD&A”) contains forward-looking statements, including statements regarding the future success of the company’s business, technology, and market opportunities. Forward-looking statements typically contain words such as “believes”, “expects”, “anticipates”, “continue”, “could”, “indicates”, “plans”, “will”, “intends”, “may”, “projects”, “schedule”, “would” or similar expressions suggesting future outcomes or events, although not all forward-looking statements contain these identifying words. Examples of such statements include, but are not limited to, statements concerning: (i) actions expected to be undertaken to achieve the company’s strategic goals; (ii) the key market drivers impacting the company’s success; (iii) intentions with respect to future biogas development work; (iv) expectations regarding business activities and orders that may be received in fiscal 2010 and beyond; (v) trends in, and the development of, the company’s target markets; (vi) the Company’s market opportunities; (vii) the benefits of the company’s products, (viii) the intention to enter into agreements with partners; (ix) future outsourcing; (x) the intention not to sell integrated biogas plants in Europe; (xi) expectations regarding competitors; (xii) the expected impact of the described risks and uncertainties; and (xiii) intentions with respect to the payment of dividends. These statements are neither promises nor guarantees, but involve known and unknown risks and uncertainties that may cause the company’s actual results, level of activity or performance to be materially different from any future results, levels of activity or performance expressed in or implied by these forward-looking statements. These risks include, generally, risks related to revenue growth, operating results, industry and products, technology, competition, the economy and other factors described in detail in Xebec’s Annual Information Form for the year ended December 31, 2009 under the heading “Risk Factors” which is available on SEDAR at www.sedar.com and on Xebec’s website at www.xebecinc.com.

Although the forward-looking statements contained herein are based upon what management believes to be current and reasonable assumptions, the company cannot assure readers that actual results will be consistent with these forward-looking statements. Examples of such assumptions include, but are not limited to: (i) trends in certain market segments and the economic climate generally; (ii) the pace and outcome of technological development; (iii) the identity and expected actions of competitors and customers; and (iv) the value of the Canadian dollar. The forward-looking statements contained herein are made as of the date of this Management Discussion and Analysis and are expressly qualified in their entirety by this cautionary statement. Except to the extent required by law, the company undertakes no obligation to publicly update or revise any forward-looking statements contained herein.

Unless specifically stated otherwise, all dollar amounts set forth in this MD&A are in Canadian dollars.

OVERALL PERFORMANCE

On June 12, 2009, Xebec completed a reverse takeover of QuestAir and became listed on the TSX. This transaction was undertaken to bring together complementary gas purification technologies, global distribution networks in high growth markets in North America, Asia and Europe, and low-cost manufacturing and supply chain capabilities. The company intends to leverage all available synergies to expand its market share in clean energies, such as biogas upgrading, natural gas dehydration and hydrogen purification. Further details regarding the transaction may be found in Note 5 to the financial statements.

Andrew Hall, the former CEO of QuestAir, relocated to China and has taken over full responsibility for the further successful development of our business in the Asia/Pacific region. This region offers Xebec excellent growth opportunities in the industrial, alternative fuel and clean-tech area. Most of the integration plan has been completed. Some additional synergies could materialize when leases expire in 2012.

Since the amalgamation, Xebec has been focusing on the development of relevant biogas upgrading solutions, which offer market leading performance metrics.

While the merger resulted in the company becoming a stronger player in the renewable natural gas and gas purification sectors, sales of certain products slowed down in the latter part of the year due to the general recessionary climate. Sales were also impacted by the fact that certain engineering service contracts were not renewed in the fourth quarter of 2009.

Late in 2008, the plant in Shanghai, China came on stream, giving Xebec an increased presence in the region, as well as being a low cost producer of quality goods. Consequently, 2009 reflects a full year of operation for the Shanghai plant compared to one quarter of operation in 2008. Regional sales offices were also opened in Singapore in January of 2009 and Newcastle (UK) in October 2009.

While revenues increased in 2009 by 11% compared to 2008, the company incurred a net loss of \$6.7 million, compared to net income of \$0.7 million in 2008. The financial results were significantly impacted by the company's mid-year merger with QuestAir, as operations were integrated, strategic direction refocused, new product development initiated and sales weakened during the fourth quarter.

In the short and medium term, the future for renewable energy is very positive. Green energy initiatives are moving up the agendas of municipal, provincial and federal governments worldwide. Corporations and consumers are increasingly looking for green energy solutions to protect the environment. We are confident that Xebec, with its complementary product lines, strong customer relationships, global footprint and low-cost manufacturing and supply chain, is well positioned to respond to this growing demand.

Our immediate efforts are focused on the acceleration of new business development. With the integration of QuestAir, Xebec is well positioned to capture market share in the expanding biogas upgrading market.

While some of our target markets were soft in the latter part of 2009, we are seeing signs of increased activity across all business segments, especially the interest for renewable energy projects in the U.S., South Korea, China, Germany, the UK, and Canada. In early 2010, Xebec was successful in signing two biogas upgrading contracts, one in California and one in South Korea.

The slowdown in sales in the last quarter of 2009 has created some pressure on cash flow during this period of transition, so the company undertook a private equity placement on November 25, 2009 for gross proceeds of \$6.4 million, to help fund ongoing operations.

SELECTED ANNUAL INFORMATION

In millions of \$ (except per share data)	2009	2008	2007*
Revenues	18.7	16.8	6.5
Net income (loss)	(6.7)	0.7	0.2
Net income (loss) per share – basic and diluted (\$/share)**	(0.42)	0.08	N.A.
Total assets (as of December 31)	20.9	10.7	4.7
Total long-term financial liabilities (as of December 31)	2.3	2.4	2.3

* 2007 financial performance data is for 9 months only.

** Xebec was not a publicly-listed company prior to June 12, 2009. For the purpose of the 2008 per share calculation, the Company has used the number of common shares issued and outstanding as of June 12, 2009.

Given the nature and early stage of Xebec's business, there are no apparent seasonal or other discernible trends at this time. The following factors can help explain some of the variations seen over this three year period.

Xebec resulted from the amalgamation with QuestAir on June 12, 2009. The comparative financial statements for 2008 are those of Xebec and the financial statements for 2009 include the accounts of QuestAir from June 12, 2009. In addition to transaction costs, there have been significant integration costs and additional operating, compliance and regulatory costs in the second half of 2009.

The company's Shanghai manufacturing facility came on-stream in the fourth quarter of 2008 and regional sales offices were opened in Singapore in the first quarter of 2009 and Newcastle in the fourth quarter of 2009.

The company incurred significant warranty expense in the fourth quarter of 2009.

RESULTS OF OPERATIONS

Revenues

Customer location

In millions of \$	Year-ended December 31,	
	2009	2008
North America	8.0	8.5
South America	3.8	-
Middle East	4.5	3.8
Asia	1.7	0.8
Europe	0.7	3.7
Total	18.7	16.8

Product line

In millions of \$	Year-ended December 31,	
	2009	2008
Natural Gas Dryers	11.1	12.2
Compressed Gas Filtration	3.0	3.6
Air Dryers	1.3	1.0
Gas Purification	1.8	-
Engineering Services	1.5	-
Total	18.7	16.8

Total revenues for 2009 were \$18.7 million, up 11% compared to \$16.8 million in 2008. The growth was driven by gas purification products and engineering services, which became a part of the company's offerings upon the merger with QuestAir. Demand for certain products declined over the period generally due to softer market conditions, particularly in North America. However, growth was realized in other regions. Sales to Asian-based customers were helped by the presence of our Shanghai facility and the opening of a sales office in Singapore to serve Southeast Asian customers and support our planned expansion in the region.

The total sales order backlog is currently approximately \$8.0 million.

Net Income

Net loss for 2009 was \$6.7 million or \$0.42 per share, compared to net income of \$0.7 million or \$0.08 per share in the same period of 2008, reflecting a \$1.9 million decline in gross profit and a \$4.0 million increase in selling and administrative costs.

Gross Profit

In millions of \$ (except Gross Margin)	Year-ended December 31,	
	2009	2008
Revenue	18.7	16.8
Cost of Goods Sold	14.5	10.7
Gross Profit	4.2	6.1
Gross Margin (%)	23%	36%

Gross profit in 2009 was \$4.2 million, down from \$6.1 million in 2008. The lower levels of gross profit and margin in 2009, compared to 2008, reflects the combined effect of higher warranty expenses and a change in the sales mix with a greater proportion of lower margin products being sold in 2009.

Warranty expenses incurred in 2009 amounting to \$1.2 million, include \$1.1 million in the fourth quarter, were significantly higher than the provisions initially made. More specifically, the higher expenses were the result of issues specific to two clients and, for each, a different product line. The issues in each case were different and, management believes, they were unique and not expected to reoccur.

Selling and Administrative

Selling and administrative expenses were \$8.8 million in 2009 compared to \$4.8 million in 2008.

The year-over-year increase is attributable to increases in staff and office facilities as a result of the QuestAir merger, the addition of office facilities in Shanghai, Singapore and Newcastle to support planned growth, and additional costs associated with being a public company.

Financial

Financial expense decreased in 2009 to \$233,862 from \$348,106 in 2008, as a result of lower interest rates and a reduction in long-term debt.

Foreign Exchange Loss

In 2009, the company had a foreign exchange loss of \$518,319 compared to a foreign exchange gain of \$239,402 in 2008. The year-over-year change was primarily due to the combination of strengthening of the Canadian dollar in 2009 and in the fair market value of derivative financial assets, thus becoming derivative financial liabilities resulting in a decrease of \$326,551 as at December 31, 2009. The derivative financial liabilities relate to Euro-denominated contracts with a foreign counterparty.

Amortization

Amortization expense increased to \$527,389 in 2009, from \$194,412 in 2008, reflecting the addition of the manufacturing facility in China in the fourth quarter of 2008, as well as the addition of property, plant and equipment with the QuestAir merger.

SUMMARY OF QUARTERLY RESULTS

In millions of \$	Year ending December 31, 2009				Year ended December 31, 2008**			
	Dec. 31	Sept 30	June 30	March 31	Restated Dec. 31	Restated Sept. 30	Restated June 30	Restated March 31
Revenues	3.8	5.9	4.3	4.7	7.4	2.7	4.7	2.0
Net income (loss)	(5.0)	(1.2)	(0.7)	0.2	1.1	(0.2)	0.2	(0.5)
Earnings (loss) per share basic and diluted*	(0.23)	(0.06)	(0.06)	0.02	0.13	(0.03)	0.02	(0.04)

* Xebec was not a publicly-listed company prior to June 12, 2009. For the purpose of the March 2009 and 2008 quarterly per share calculations, the company has used the number of common shares issued and outstanding as of June 12, 2009.

** Some quarterly results for 2008 differ from previously disclosed following a change in the restatement.

Given the nature and early stage of Xebec's business, there are no apparent seasonal or other discernible trends at this time.

Xebec resulted from the amalgamation with QuestAir on June 12, 2009. The financial results for the last three quarters of 2009 include the accounts of QuestAir from June 12, 2009. The first quarter of 2009 and the four quarters of 2008 are those of Xebec. In addition to transaction costs, there have been integration costs and additional operating, compliance and regulatory costs in the second half of 2009.

LIQUIDITY AND CAPITAL RESOURCES

The company's cash flows from operating, investing and financing activities, as reflected in the consolidated statements of cash flows, are summarized in the following table:

(in millions of Canadian dollars)	For years-ended December 31,		
	2009	2008	Change
	\$	\$	\$
Cash provided (used) by operating activities	(3.2)	(0.9)	(2.3)
Cash provided (used) by investing activities	3.4	(0.7)	4.1
Cash provided (used) by financing activities	4.8	1.8	3.0

Given the nature and early stage of Xebec's business, the company has required external financing to meet its operating and investing cash needs.

In 2009, the company's operating activities used more cash than in 2008 because of the net loss incurred, partially offset by increases in cash from working capital. Investing activities were a net provider of cash as Xebec acquired \$5.0 million of cash in its merger with QuestAir and cash provided by financing activities was higher as the company raised an additional \$5.9 million of cash (net of issuance costs) in a private equity placement in November 2009. These funds were used to finance operations and investments, as well as repay debt.

As of December 31, 2009, the company had \$5.4 million of cash on hand, \$0.5 million outstanding in short-term bank loans, and \$2.3 million of long-term debt outstanding, of which \$0.4 million is due in 2010.

The company has access to credit facilities in the amount of \$1,500,000 which bear interest at the company's bank prime rate plus 0.60% per annum and are limited by certain margin requirements concerning accounts receivable. In addition, the company has access to credit facilities in the amount of \$500,000 which bear interest at the company's bank prime rate plus 1.50% per annum and are limited by certain requirements concerning pre-shipment costs. The bank loan is secured by a first ranking hypothec of \$4,000,000 on all movable property of the company. The company must also comply with covenants requiring a minimum current ratio and maximum funded debt to tangible net worth. As at December 31, 2009, the company is in compliance with these covenants. As at year-end, the unused amount is approximately \$1,500,000 for the first credit facility and \$3,100 for the second facility.

As well, the company has access to a revolving demand facility by way of letters of credit and letters of guarantee amounting to \$1,000,000. As at December 31, 2009, the unused portion of this demand facility is approximately \$922,000 (\$869,000 in 2008).

The following table is a summary of the contractual obligations including payments due for each of the next five years and thereafter.

Contractual Obligations (In millions of \$)	Payments Due by Period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Long Term Debt	2.3	0.4	0.3	0.3	1.3
Operating Leases	1.2	0.6	0.4	0.2	
Total Contractual Obligations	3.5	1.0	0.7	0.5	1.3

Liquidity risk is the risk that the company will not be able to meet its financial obligations as they come due. For further information, please see the section entitled "Financial and Other Instruments".

OUTSTANDING SHARE DATA

The authorized share capital of the company consists of an unlimited number of common shares and an unlimited number of preferred shares. No preferred shares are issued.

Common Shares

On June 12, 2009, a total of 8,638,496 common shares were deemed to be issued and outstanding prior to the reverse takeover of QuestAir. Upon conversion of 300,000 preferred shares of former Xebec Adsorption, 769,231 common shares were issued to a shareholder of Xebec. Upon the reverse takeover, an additional 11,269,318 common shares, representing the common shares historically issued to the shareholders of QuestAir, were deemed to have been issued by the Company.

On November 25, 2009 Xebec completed a private placement and issued a total of 8,585,400 units at a price of \$0.75 per unit for gross proceeds of \$6,439,050. The net proceeds from the issuance after underwriting fees and offering expenses amounted to \$5,886,298. Each unit consisted of one common share of Xebec and one half of one common share purchase warrant, entitling the holder of one whole warrant to purchase one additional common share from treasury at an exercise price of \$1.10 until May 25, 2011.

As a result of the business combination (described in Note 5 of the financial statements), the company also issued 5,834,249 common shares, which are being held in escrow and could be released to the former Xebec shareholders on the achievement of specified financial targets measured at December 31, 2009 and 2010. The targets for December 31, 2009 were not met. Consequently, these shares continue to be considered restricted share awards that are issued, but not outstanding. The expense related to these awards is recorded based on management's best estimate of the ultimate achievement of the financial targets over the vesting periods. Amounts recorded for share award expense during 2009 were reversed in the fourth quarter, resulting in a nil amount for 2009. Amounts may be recorded in 2010.

As a result, Xebec now has as of March 29, 2010, 35,096,694 common shares issued, including 5,834,249 common shares held in escrow, as described above.

Share Purchase Warrants Outstanding

As at December 31, 2009, 17,167,824 warrants were outstanding, of which 12,180,000 warrants entitle the holder to acquire one additional common share per warrant at a price of \$2.15 until May 13, 2010, and 180,000 warrants entitle the holder to acquire one common share per warrant at a price of \$1.50 until May 13, 2010. Of the remaining 4,807,824 warrants, 4,292,700 warrants entitle the holder to acquire one common share per warrant at a price of \$1.10 until May 25, 2011 and 515,124 warrants entitle the holder to acquire one common share at a price of \$0.77 per share until May 25, 2011.

These latter warrants are subject to an accelerated expiry if, at any time after December 31, 2009, the published closing trade price of the Common Shares on the Toronto Stock Exchange ("TSX") is equal or superior to \$1.60 for any 20 consecutive trading days, in which event Xebec may give the holder a written notice that the warrants will expire at 5:00 p.m. (Toronto Time) on the 30th day from the receipt of such notice.

The ability to exercise the 6,180,000 warrants issued on the reverse takeover transaction is contingent on the exercise of the remaining pre-existing warrants.

Stock Options Outstanding

Upon the reverse takeover, the company assumed QuestAir's omnibus plan (the "Plan"), which allows for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards and other stock-based awards. Under the Plan, common shares approved for issuance under all stock-based compensation arrangements are limited to the greater of 591,560 or 10% of the common shares issued and outstanding. As at December 31, 2009, the maximum number of common shares available for issuance under all stock-based compensation arrangements is 2,696,839.

Under the terms of the Plan, stock options are granted with an exercise price not less than the volume weighted average trading price of the common shares for the five trading days prior to the date of grant. Stock options generally vest quarterly over four years and are exercisable for seven years from the date of grant.

As at December 31, 2009, the Company had 139,052 options outstanding under the plan with a weighted average exercise price of \$5.49.

CONTINGENT OFF-BALANCE SHEET FINANCING ARRANGEMENTS

Prior to the transaction on June 12, 2009, Xebec received funding contributions from various programs of the Canadian Government to support the development and commercialization of our gas purification technology. The company has not entered into any new contingent off-balance sheet financing arrangements since then.

A summary of these funding arrangements is provided in the tables below:

Technology Partnerships Canada (TPC)

At September 30, 2008, QuestAir had received \$8,139,937 under a conditionally repayable loan under the TPC funding program, through an agreement administered by Industry Canada. These funds are repayable in the form of annual royalties under certain conditions. During the year, QuestAir finalized negotiations with TPC to amend this agreement to, among other things, eliminate certain development milestones, extend the program completion date for certain other milestones, and reduce the contribution amount and the associated royalties. Amounts drawn under this contribution agreement are subject to final audit by Industry Canada. QuestAir entered into a similar funding arrangement with TPC in 1999 and received a total of \$4,762,503 in funding from March 1999 to July 2002. The funding is also repayable under certain conditions. The repayment obligations and total royalty repayments made to date for these funding programs are listed below:

Funding Award Date	Description	Royalties	Term	Royalty Payments to Date
June 6, 2003	Fast Cycle Pressure Swing Adsorption	Annual royalties of 1.165% (0.471% from October 1, 2009 thereafter) of gross business revenues	The royalty period began on October 1, 2005 and will end on the earlier of September 30, 2022 or until a cumulative royalty ceiling of \$18.8 million is reached.	Total cumulative payments: \$797,967 Accrued for future payment: \$165,557
March 31, 1999	Pulsar Pressure Swing Adsorption Program	Annual royalties of 1.8% of gross project revenues and fuel cell related products	Royalty period extends to the later of the date of payment of all amounts due to the Minister and 2015. The maximum cumulative repayment is \$8.75 million.	Total cumulative payments: \$56,726 Accrued for future payment: \$0

Department of Natural Resources Efficiency and Alternative Energy Program

In 2005, QuestAir was awarded a grant for \$225,000 from the Government of Canada under the Department of Natural Resources Efficiency and Alternative Energy Program. In 2004, QuestAir received a similar funding award of \$193,944 under the same funding program. Both funding awards are repayable under certain conditions. The repayment obligations and total royalty repayments made to date for these funding programs are listed below:

Funding Award Date	Description	Royalties	Term	Royalty Payments to Date
January 4, 2005	Development of structured adsorbent for the production of high purity hydrogen	Annual royalties of 0.12% of gross project revenues	Royalty period starts on date of first gross project revenues and extends to March 31, 2015, to a maximum cumulative repayment of \$225,000, whichever occurs first.	Total cumulative payments: \$5,592 Accrued for future payment: \$0
January 6, 2004	Development of a device that increases the efficiency of a high temperature fuel cell system	Annual royalties of 0.12% of gross project revenues	Royalty period starts on date of first gross project revenues and extends to March 31, 2014, to a maximum cumulative repayment of \$193,944, whichever occurs first.	Total cumulative payments: \$0 Accrued for future payment: \$0

FINANCIAL AND OTHER INSTRUMENTS

Liquidity Risk

Although the company has incurred an operating loss of \$6,732,414 and had cash outflows from operations of \$3,244,860 for the year ended December 31, 2009, the company finished the year with cash amounting to \$5,447,702, working capital of \$5,083,707 and had access to unused credit facilities totaling \$1,500,000. During the fourth quarter of 2009, management concluded a share offering which provided the company with net proceeds of \$5,886,298, the company also undertook various initiatives and developed a plan to manage its operating and liquidity risks in light of prevailing economic conditions. The company has prepared a budget for 2010 for which management believes the assumptions are reasonable. Achieving budgeted results is dependent on improving the volume of revenues, delivering on sales and contracts schedules, meeting expected overall operating margin levels and controlling general and administrative costs. management expects to meet its budget and to have enough liquidity to fund operations to at least beyond December 31, 2010.

The company is thus faced with uncertainties that may have an impact on future operating results and liquidity. These uncertainties include reduced spending in renewable energy projects reflecting the weakness in the economy, fluctuations in foreign currency rates and achieving the company's business plan goals as mentioned in the previous paragraph, which includes the development of a new business segment. While management believes it has developed planned courses of action to mitigate operating and liquidity risks, there is no assurance that management will be able to achieve its business plan and maintain the necessary liquidity level if events or conditions develop that are not consistent with management's expectations, key budget assumptions for 2010 and planned courses of action. Therefore, the company may require additional external funding and there is no assurance that it would be successful. It is possible that future changes in capital markets conditions could result in such funding not being available when required. The company is unable to predict the possible effects, if any, of such uncertainties and the potential adjustments to the carrying values of assets and liabilities that could be needed should the company have insufficient liquidity. Such adjustments could be material.

Currency Risk

The company realizes approximately 64% of its sales and 54% of its purchases in foreign currency. Consequently, some assets and liabilities are exposed to foreign exchange fluctuations. The company does not use financial instruments to reduce this risk.

Management does not believe that the impact of foreign exchange fluctuations will be significant and, therefore, has not provided a sensitivity analysis of the impact of fluctuations on net loss and comprehensive loss.

Interest Rate Risk

Interest rate risk is the risk that the fair value or future cash flows of financial instruments will fluctuate as market interest rates change.

The company is exposed to interest rate risk on its bank debt, both short-term and long-term, for which the interest rates charged fluctuate based on the bank prime rate. The short-term bank loan as at December 31, 2009 is \$496,900 (2008 – \$1,760,931) and the long-term debt that is subject to the variability of the interest rate fluctuation is \$1,961,266 (2008 – \$2,047,900). The annual interest is the bank prime rate plus 0.60%. If the interest rate on the bank debt had been 50 basis points higher (lower), related to the bank debt outstanding during fiscal 2009, net income would have been \$12,300 (2008 – \$21,800) higher (lower).

TRANSACTIONS WITH RELATED PARTIES

Other than Kurt Sorschak, President and CEO of Xebec, there are no material interests, direct or indirect, of any of the company's directors, executive officers, senior officers, any direct or indirect shareholder of Xebec who beneficially owns, or who exercise control, over more than 10% of the company's outstanding shares or any known associate or affiliate of such persons, in any transaction within the three most recently completed financial years or during the current financial year that has materially affected or will materially affect Xebec. Kurt Sorschak beneficially owns, or controls or directs, directly or indirectly 13,757,778 common shares of Xebec representing more than 10% of any class or series of the company's outstanding voting securities, of which 5,250,823 are subject to escrow.

FOURTH QUARTER RESULTS

Revenues

Customer location

In millions of dollars	Three months ended December 31,	
	2009	2008
Middle East	0.1	3.8
North America	2.4	2.0
South America	0.7	-
Europe	-	1.1
Asia	0.6	0.5
Revenue	3.8	7.4

Product line

In millions of dollars	Three months ended December 31,	
	2009	2008
Natural Gas Dryers	1.7	5.9
Compressed Gas		
Filtration	0.9	1.4
Air Dryers	0.3	0.1
Gas Purification	0.3	-
Engineering Services	0.6	-
Revenue	3.8	7.4

Revenue for the fourth quarter of 2009 was \$3.8 million, \$3.6 million less than in 2008. In the fourth quarter of 2008 there was a significant clustering of natural gas dryer sales to Middle-East-based customers, which did not reoccur in 2009. As well, sales in the fourth quarter of 2009 slowed down somewhat following the merger with QuestAir and the company's transition to a focus on the biogas upgrading market.

Net Income

A net loss of \$5.0 million, or \$0.23 per share, was recorded for the fourth quarter of 2009, compared to net income of \$1.1 million, or \$0.13 per share, in the same period of 2008, reflecting a \$3.8 million decline in gross profit and a \$2.2 million increase in selling and administrative costs.

Gross Profit

In millions of dollars (except Gross Margin)	Three months ended December 31,	
	2009	2008
Revenue	3.8	7.4
Cost of Goods Sold	4.8	4.1
Gross Profit (Loss)	(1.0)	3.3
Gross Margin	(26%)	45%

The company incurred a gross loss of \$1.0 million in the fourth quarter of 2009, compared to a gross profit of \$3.2 million in the fourth quarter of 2008. The lower levels of gross profit and margin in 2009 compared to 2008, reflect the combined effect of higher warranty expenses, amounting to \$1.1 million in the fourth quarter of 2009 and lower sales.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Financial statements prepared in accordance with Canadian GAAP require management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The following accounting policies involve the use of estimates which could possibly change between reporting periods in a way that could have a material impact on the financial results of the company. Also refer to Note 3 of the financial statements where other estimates are described.

Warranty Provision

During the normal course of its operations, Xebec assumes certain maintenance and repair costs under warranties offered on dryers and filters. 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, the company relies on historical information to develop its estimates. Given the nature and early stage of the company's business, there is not a lot of historical information on which to base these estimates. As well, actual results may be impacted by unique, one-time events or circumstances. In the latter part of 2009, the company incurred warranty-related expenses which were materially higher than the provisions initially established. The higher expenses were the result of issues specific to two clients and, for each, a different product line. The issues in each case were different and, management believes, they were unique and not expected to reoccur.

Future Income Tax

The company uses the liability method to record income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using substantively enacted rates in effect when the differences are expected to reverse. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period that includes the substantial enactment date. Future income tax assets are evaluated and if realization is not considered to be more likely than not, a valuation allowance is provided.

In assessing the realizability of future tax assets, management considers whether it is more likely than not that some portion or all of the future tax assets will be realized. The ultimate realization of future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. As management believes there is sufficient uncertainty regarding the realization of future tax assets, a full valuation allowance has been provided.

The company has non-capital losses carried forward in Canada of approximately \$49,900,000, which are available to reduce taxable income in future years, the benefit of which has not been recorded in the accounts, and which expire as follows:

	\$
2014	4,900,000
2015	5,900,000
2025	6,900,000
2026	7,200,000
2027	6,800,000
2028	10,500,000
2029	7,700,000
	<u>49,900,000</u>

The company also has non-capital losses carried forward in Singapore of approximately \$205,000, which are available to reduce taxable income of future years for an unlimited future period.

The company has scientific research and experimental development expenses of \$23,800,000 which are available to be carried forward indefinitely and deducted against future taxable income otherwise calculated.

As of December 31, 2009, the company also has investment tax credits of approximately \$8,300,000 available to offset future Canadian federal and provincial income taxes payable. The investment tax credits began to expire in 2007. The potential benefit of the investment tax credit has not been recognized in the accounts and expires as follows:

	\$
2010	870,000
2011	240,000
2012	510,000
2013	270,000
2014	410,000
2015	360,000
2016	260,000
2017	160,000
2018	100,000
2019	470,000
2020	910,000
2021	240,000
2022	920,000
2023	480,000
2024	740,000
2025	650,000
2026	410,000
2027	240,000
2029	60,000
	<u>8,300,000</u>

CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION

Goodwill and Intangible Assets

On January 1, 2009, the Company adopted Canadian Institute of Chartered Accountants (“CICA”) Section 3064, “Goodwill and Intangible Assets”, which replaces Section 3062, “Goodwill and Other Intangible Assets”, and which resulted in (i) the withdrawal of Section 3450, “Research and Development Costs” and Emerging Issues Committee Abstract 27, “Revenues and Expenditures During the Pre-operating Period”, and (ii) the amendment of Accounting Guideline 11, “Enterprises in the Development Stage”. This new standard provides guidance on the recognition of intangible assets in accordance with the definition of an asset and the criteria for asset recognition, whether those assets are separately acquired or internally developed, as well as clarification on the application of the concept of matching revenues and expenses. The adoption of Section 3064 eliminated the deferral of start-up costs, which are now recognized as an expense when they are incurred. Consequently, the company adjusted opening retained earnings as if the new rules had always been applied in the past and the prior period figures have been restated. As well, the company made reclassifications in order to present certain assets, mainly software, as intangible assets instead of presenting them as property, plant and equipment.

As a result of the adoption of these new rules, the following tables summarize the adjustments that were made to the consolidated balance sheet as at December 31, 2008 and to the statement of income for the year then ended:

	As at December 31, 2008 \$
Balance sheet	
Increase (decrease) in	
Property, plant and equipment	(143,619)
Intangible assets	(446,022)
Future income tax liabilities	16,424
Retained earnings	(573,217)
	For the year-ended December 31, 2008
Statement of income	
Increase (decrease) in	
Amortization of property, plant and equipment	(44,869)
Amortization of intangible assets	2,206
Costs of goods sold	130,408
Selling and administrative	468,654
Future income tax	(16,424)
Net loss for the year	(540,005)
Loss per share – Basic and diluted	(0.06)

On January 20, 2009, the Company adopted the recommendation of the Emerging issues Committee No. 173, "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities" (EIC – 173) issued by the CICA. This abstract clarifies that an entity's own credit risk and the credit risk of its counterparty should be taken into consideration in determining the fair value of financial assets and liabilities. The prospective adoption of this section did not have a material impact on the company's consolidated financial statements.

In June 2009, the Company adopted the amendments to Section 3862, "Financial Instruments – Disclosures", issued by the CICA. The amendments improved disclosures are about fair value measurements of financial instruments, including the relative reliability of the inputs used in those measurements and liquidity risk, in light of concerns that the nature and extent of liquidity risk requirements were unclear and difficult to apply. The amendments to Section 3862 apply to annual financial statements relating to fiscal years ending after September 30, 2009. The prospective adoption of this section did not have any measurement impact on the company's consolidated financial statements. The additional disclosure requirements are presented in note 27.

RECENTLY ISSUED ACCOUNTING STANDARDS

Business Combinations

Section 1582, "Business Combinations", which replaces Section 1581, "Business Combinations". The Section establishes standards for the accounting for a business combination. It provides the Canadian equivalent to the IFRS standard, IFRS 3 (Revised), "Business Combinations". The Section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Earlier application is permitted. The Company is currently evaluating the impact of the adoption of this new Section on the consolidated financial statements.

Consolidated Financial Statements, and Non-Controlling Interests

Section 1601, "Consolidated Financial Statements", and Section 1602, "Non-controlling Interests", which together replace Section 1600, "Consolidated Financial Statements", Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of IFRS standard, IAS 27 (Revised), "Consolidated and Separate Financial Statements". The Sections apply to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier adoption is permitted as of the beginning of a fiscal year. The Company is currently evaluating the impact of the adoption of these new Sections on the consolidated financial statements.

International Financial Reporting Standards (IFRS)

The AcSB announced that accounting standards in Canada are to converge with IFRS. The changeover date from current Canadian GAAP to IFRS has been established as January 1, 2011. While IFRS use a conceptual framework similar to Canadian GAAP, there are significant differences in accounting policy which must be addressed.

A diagnostic assessment is being planned for the early part of 2010 to examine the extent of the impact that the conversion may have on financial reporting, business processes and information systems. The company's current plan is aimed in particular at identifying the differences between IFRS and the company's current accounting policies, as well as assessing the impact of various accounting alternatives offered pursuant to IFRS. In addition, a high level assessment of the company's Information Technology Systems and tax processes will be conducted. The financial impact of the transition to IFRS cannot be reasonably estimated at this time, however, there may be changes in accounting policies and these may impact the company's financial statements.

DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING

In order for the company to comply with its disclosure requirements under applicable securities laws, the company and its consolidated subsidiaries must maintain controls and procedures that are designed to provide reasonable assurances that material information disclosed in this MD&A and related financial statements is properly recorded, processed, summarized and reported in a timely manner to the Board of Directors and the Audit Committee.

The company's management, under the direction and supervision of the Chief Executive Officer and Chief Financial Officer, is also responsible for establishing and maintaining internal control over financial reporting (ICFR). These controls are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP.

The company's management has performed a high-level, minimally-documented evaluation of the effectiveness of the company's disclosure controls and procedures, as well as its internal control over financial reporting. Certain weaknesses were identified. Specifically, the company did not have sufficient accounting documentation, policy, procedures or segregation of duties for certain transaction cycles.

To address the above issues, the company is recruiting additional financial staff at the head office to oversee the financial reporting, and has consulted with tax advisors on various issues. The company continues to determine other appropriate remediation plans, such as reviewing the organizational structure of the accounting group, to strengthen its resources to reflect the company's growth. However, the reverse takeover and integration of QuestAir in the second half of the year has required the dedication and efforts of key management and financial resources during this period. Thus, while the company has been making progress, there have been some

delays in implementing the remediation plans.

The company is also planning to conduct a more detailed and documented evaluation of its ICFR compliance under National Instrument 52-109, which is expected to be completed in 2010. An independent professional firm has also been consulted to help the Company, in 2010, develop processes to convert to IFRS.

Furthermore, a formal Disclosure Policy and Authorization Policy has recently been approved by the Board of Directors. A formal Disclosure Committee will be established to oversee corporate disclosures, and the Disclosure Policy and the Authorization Policy will be communicated to senior management and implemented throughout the Company. This entire process is expected to be completed in 2010.

The company believes that the weaknesses in internal control over financial reporting have been mitigated by the active involvement of senior management and the Board of Directors in all the affairs of the company; open lines of communication within the company; the present levels of activities and transactions within the company being readily transparent; and the thorough review of the company's financial statements by management and the Board of Directors.

Based upon the results of management's evaluation, the company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, the company's disclosure controls and procedures were sufficiently effective to provide reasonable assurance that the information required to be disclosed in reports it files is recorded, processed, summarized and reported within the appropriate time periods and forms.

The company's management believes that the consolidated financial statements for the period ended December 31, 2009, to which this MD&A relates, correctly presents in all material aspects the company's financial position, results of operations and cash flows for the period covered therein.