Xebec Adsorption Inc.

Consolidated Financial Statements
December 31, 2017 and 2016
(expressed in Canadian dollars)

Xebec Adsorption Inc.

Consolidated Statements of Financial Position

As at December 31, 2017 and 2016

(expressed in Canadian dollars)

	2017 $	2016 $
Assets		
Current assets		
Cash	1,341,121	1,088,592
Trade and other receivables (Note 5)	4,133,259	2,449,441
Inventories (Note 6)	1,963,392	1,329,516
Investment tax credits receivable	15,943	47,953
Other current assets	260,157	188,297
Total current assets	7,713,872	5,103,799
Non-current assets		
Property, plant and equipment (Note 7)	208,632	274,538
Intangible assets (Note 8)	418,363	190,743
Total non-current assets	626,995	465,281
Total assets	8,340,867	5,569,080
Liabilities		
Current liabilities		
Bank loan (Note 9)	-	755,000
Credit facility (Note 10)	1,437,912	-
Trade, other payables and accrued liabilities (Note 11)	3,585,755	3,623,259
Deferred revenue (Note 12)	720,996	942,575
Current portion of long-term debt (Note 13a))	22,236	22,112
Current portion of government royalty program obligation (Note 13b))	86,826	757,540
Current portion of provisions (Note 14)	16,689	209,133
Total current liabilities	5,870,414	6,309,619
Non-current liabilities		
Long-term debt (Note 13 a))	2,223,478	774,788
Government royalty program obligation (Note 13 b))	504,546	-
Obligation arising from shares issued by a subsidiary (Note 15)	3,912,314	3,582,135
Government grants	-	2,083
Deferred rent	132,815	138,516
Provisions (Note 14)	5,601	8,926
Deferred tax liability	81,989	-
Total non-current liabilities	6,860,743	4,506,448
Total liabilities	12,731,157	10,816,067
Equity		
Share capital (Note 16)	19,703,836	19,318,856
Contributed surplus	3,339,740	2,996,621
Equity component of convertible debentures	291,389	150,304
Accumulated other comprehensive loss	(1,049,455)	(940,216)
Deficit	(26,675,800)	(26,772,552)
Total equity	(4,390,290)	(5,246,987)
Total liabilities and equity	8,340,867	5,569,080

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

Approved by the Board of Directors

(signed) Kurt Sorschak Director

(signed) Joseph Petrowski Director

Xebec Adsorption Inc.

Consolidated Statements of Income (Loss)
For the years ended December 31, 2017 and 2016

(expressed in Canadian dollars)

	2017 $	2016 $
Revenue (Note 27)	14,745,931	9,587,381
Cost of goods sold	8,977,709	7,419,727
Gross margin	5,768,222	2,167,654
Research and development expenses (Note 19)	(31,114)	142,696
Selling and administrative expenses	5,217,075	4,354,639
Foreign exchange loss	131,149	213,303
Insurance compensation for damage to inventories	(132,366)	-
Gain on conversion of shares issued by a subsidiary (Note 15)	(2,358)	(352,248)
	5,182,386	4,358,390
Operating income (loss)	585,836	(2,190,736)
Other charge (income)		
Finance income	(122,068)	(3,893)
Finance expenses (Note 20)	611,152	543,916
	489,084	540,023
Income (loss) before income taxes	96,752	(2,730,759)
Income taxes (Note 22)	-	(59,316)
Net income (loss) for the year	96,752	(2,671,443)
Net income (loss) per share		
Basic and diluted net income (loss) per share (Note 16)	0.002	(0.07)

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

Xebec Adsorption Inc.
Consolidated Statements of Comprehensive Income (Loss)
For the years ended December 31, 2017 and 2016
(expressed in Canadian dollars)

	2017 $	2016 $
Net income (loss) for the year	96,752	(2,671,443)
Other comprehensive income (loss)		
Cumulative translation adjustment	(109,239)	165,605
Comprehensive loss for the year	(12,487)	(2,505,838)

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

Xebec Adsorption Inc.

Consolidated Statements of Changes in Equity

For the years ended December 31, 2017 and 2016

(expressed in Canadian dollars)

	Number						Amount
	Common shares	Share capital – Common shares $	Contributed surplus $	Accumulated other comprehensive income (loss) $	Deficit $	Equity Component of convertible debentures $	Total $
Balance – January 1, 2016	39,363,867	19,318,856	2,925,379	(1,105,821)	(24,101,109)	-	(2,962,695)
Net loss for the year	-	-	-	-	(2,671,443)	-	(2,671,443)
Other comprehensive income	-	-	-	165,605	-	-	165,605
Comprehensive income (loss) for the year	-	-	-	165,605	(2,671,443)	-	(2,505,838)
Issuance of convertible debentures (net of deferred tax liability of $ 59,316 (Note 22)						150,304	150,304
Stock-based compensation expense (Note 17)	-	-	71,242	-	-		71,242
Balance – December 31, 2016	39,363,867	19,318,856	2,996,621	(940,216)	(26,772,552)	150,304	(5,246,987)
Balance – January 1, 2017	39,363,867	19,318,856	2,996,621	(940,216)	(26,772,552)	150,304	(5,246,987)
Net income for the year	-	-	-	-	96,752	-	96,752
Other comprehensive loss	-	-	-	(109,239)	-	-	(109,239)
Comprehensive loss for the year	-	-	-	(109,239)	96,752	-	(12,487)
Stock-based compensation (Note 17)	-	-	372,603	-	-	-	372,603
Issuance of convertible debentures (net of deferred tax liability of $ 81,989 (Note 22)						186,177	186,177
Share issued from the exercise of options	1,140,500	88,535	(29,484)	-	-	-	59,051
Conversion of convertible debentures	2,000,000	296,445	-	-	-	(45,092)	251,353
Balance – December 31, 2017	42,504,367	19,703,836	3,339,740	(1,049,455)	(26,675,800)	291,389	(4,390,290)

Accumulated other comprehensive income (loss) relates solely to cumulative translation adjustments.

The accompanying notes are an integral part of the consolidated financial statements.

Xebec Adsorption Inc.

Consolidated Statements of Cash Flows

For the years ended December 31, 2017 and 2016

(expressed in Canadian dollars)

	2017 $	2016 $
Cash flows from		
Operating activities		
Net income (loss) for the year	96,752	(2,671,443)
Items not affecting cash		
Depreciation of property, plant and equipment (Note 7)	87,584	94,785
Amortization of intangible assets (Note 8)	80,325	76,837
Reversal of inventory write-down (Note 6)	(189,065)	(17,420)
Government grant	(2,083)	(5,000)
Accretion finance expenses and gain on revaluation of government royalty program obligation (Note 13b))	(91,168)	33,499
Accretion of the obligation arising from shares issued by a subsidiary (Note 15)	332,537	350,575
Accretion of convertible debentures (Note 13 a))	86,549	16,327
Stock-based compensation expense (Note 17)	372,603	71,242
Future income taxes (Note 22)	-	(59,316)
Reversal of trade payables	(697,659)	(657)
Reversal of allowance for doubtful accounts (Note 18)	(315,145)	-
Deferred rent	(5,701)	26,384
	(244,471)	(2,084,187)
Change in non-cash working capital balances related to operations (Note 23)	(1,610,526)	(655,667)
	(1,854,997)	(2,739,854)
Investing activities		
Acquisition of property, plant and equipment	(26,110)	(55,605)
Acquisition of intangible assets	(308,702)	(28,894)
	(334,812)	(84,499)
Financing activities		
Increase (decrease) of bank loan	(755,000)	380,000
Proceeds from debenture units	2,024,149	1,000,000
Debenture issue costs	(129,390)	(51,928)
Increase from obligation under capital lease	11,327	42,120
Credit facility (Note 10)	1,437,912	-
Proceeds from issuance of share capital (Note 17)	59,051	-
Repayment of long-term debt	(24,303)	-
Repayment of government royalty program obligation (Note 13b))	(75,000)	-
	2,548,746	1,370,192
Net increase (decrease) in cash during the year	358,937	(1,454,161)
Cash – Beginning of year	1,088,592	2,717,965
Effect of exchange rate changes on cash	(106,408)	(175,212)
Cash and cash equivalent – End of year	1,341,121	1,088,592
Additional information		
Interest paid	378,098	143,515

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

1 Nature of business and liquidity risk

a) Nature of business

Xebec Adsorption Inc. ("Xebec" or the "Company") is a global provider which specializes in the design and manufacture of cost-effective and environmentally responsible purification, separation, dehydration and filtration equipment for gases and compressed air. Xebec's main product lines are: biogas plants for the purification of biogas from agricultural digesters, landfill sites and waste water treatment plants, natural gas dryers for natural gas refuelling stations, associated gas purification systems which enable diesel displacement on drilling sites, and hydrogen purification systems for fuel cell and industrial applications. The Company is incorporated and domiciled in Canada and is listed on the TSX Venture (TSXV) Exchange under the symbol XBC-V. The address of its registered office is 730 Industriel Boulevard, Blainville, Quebec, Canada. The Company's web site address is www.xebec.com.

b) Going concern

The consolidated financial statements have been prepared on the basis of the going concern assumption, meaning that the Company will be able to realize its assets and discharge its liabilities in the normal course of operations. The Company has realized an operating income of $585,836 (an operating loss of $2,190,736 in 2016), had cash outflows from operations of $1,854, 997 for the year ended December 31, 2017 ($2,739,854 in 2016) , finished the year with cash amounting to $1,341,121 ($1,088,592 in 2016) and a working capital of $1,843,458 (a negative working capital of $1,205,820 in 2016) and had access to credit facilities totalling $750,000 of which $0 ($755,000 in 2016) has been used (see Note 9). During the year, management undertook various initiatives and developed a plan to manage its operating and liquidity risks in light of prevailing economic conditions. Management is also currently seeking alternative financings for its operations. The Company has prepared a budget for 2018 for which management believes the assumptions are reasonable. Achieving budgeted results is dependent on improving the volume of revenues, delivering on sales and contract schedules, meeting expected overall operating margin levels and controlling general and administrative costs.

The Company is thus faced with uncertainties that may have an impact on future operating results and liquidity. These uncertainties include fluctuations in foreign currency rates and achieving the Company's business plan goals as mentioned in the previous paragraph. 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 including accessing liquidities from China if events or conditions develop that are not consistent with management's expectations, key budget assumptions for 2018 and planned courses of action. Therefore, the Company may require additional external funding, and there is no assurance that it would be successful. Future changes in capital markets conditions could result in such funding not being available when required or at acceptable costs. 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.

2 Basis of compliance and basis of preparation

The Company prepares its consolidated financial statements in accordance with International Financial Reporting Standards (IFRS).

These consolidated financial statements were approved for issue by the Board of Directors of the Company on April 23, 2018.

The consolidated financial statements have been prepared on the historical cost convention, except for where IFRS requires recognition at fair value

These consolidated financial statements are based on the accounting policies as described below. These policies have been consistently applied to all the periods presented, unless otherwise stated.

3. Significant accounting policies

Basis of consolidation

These consolidated financial statements include the accounts of the Company and its subsidiaries. Subsidiaries are entities controlled by the Company. Control is achieved when the Company:

- has power over the investee;
- is exposed, or has rights, to variable returns from its involvement with the investee; and
- has the ability to use its power to affect its returns.

The Company reassesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed above.

When the Company has less than a majority of the voting rights of an investee, it has power over the investee when the voting rights are sufficient to give it the practical ability to direct the relevant activities of the investee unilaterally. The Company considers all relevant facts and circumstances in assessing whether or not the Company's voting rights in an investee are sufficient to give it power, including:

- the size of the Company's holding of voting rights relative to the size and dispersion of holdings of the other vote holders;

- potential voting rights held by the Company, other vote holders or other parties;

- rights arising from other contractual arrangements; and

- any additional facts and circumstances that indicate that the Company has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

Intercompany transactions, balances and unrealized gains and losses on transactions between different entities within the Company are eliminated. Subsidiaries comprise Xebec Adsorption (Shanghai) Co. Ltd., which is 70% owned, Xebec Adsorption USA Inc. (Houston) and Xebec Adsorption Europe SARL which are wholly owned. 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 has the obligation to repurchase the Minority Shareholders' interest owned in Xebec Adsorption (Shanghai) Co. Ltd. under certain circumstances (see Note 15). Therefore, the accounts of Xebec Adsorption (Shanghai) Co. Ltd. are consolidated at 100% and the Minority Shareholders' interest is presented as a financial liability in these consolidated financial statements.

Changes in the Company's ownership interests in subsidiary that do not result in the Company losing control over the subsidiaries are accounted for as equity transactions or liability transactions depending on the conditions that these changes occurred. The carrying amounts of the Company's interests are adjusted to reflect the changes in their relative interests in the subsidiaries.

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. Net realizable value is the estimated selling price for inventories less all estimated costs of completion and cost necessary to make the sale. Inventories are recorded net of any obsolescence provision.

A new assessment is made in each subsequent year 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 writedown is reversed (i.e. the reversal is limited to the amount of the original writedown) 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 consolidated statement of income (loss) during the year in which they are incurred.

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

Machinery and equipment	3 to 10 years
Office furniture and equipment	2 to 5 years
Computers	3 years
Moulds	5 years
Vehicles	5 years

The Company allocates the amount initially recognized in respect of an item of property, plant and equipment to its significant components and depreciates each such component 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 consolidated statement of income (loss).

Identifiable intangible assets

The Company's intangible assets consist of software, capitalized development costs of a new line and engineering standardisation costs when the criteria mentioned in the research and development expenses accounting policy are met. These assets are capitalized and amortized on a straight-line basis in the consolidated statement of income (loss) over the period of their expected useful lives.

Development costs and engineering standardisation costs are amortized over a period of five years. Software is amortized over a period of 3 years.

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 depreciated or 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 for potential reversals when events or circumstances warrant such consideration.

Provisions

Provisions for 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 year 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.

During the normal course of its operations, the Company assumes certain maintenance and repair costs under warranties offered on natural gas equipment, biogas, associated gas and hydrogen 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 instruments. 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.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

Cash	Loans and receivables
Trade and other receivables	Loans and receivables
Bank loan	Financial liabilities
Credit facility	Financial liabilities
Trade and other payables and accrued liabilities	Financial liabilities
Long-term debt	Financial liabilities
Government royalty program obligation	Financial liabilities
Obligation arising from shares issued by a subsidiary	Financial liabilities

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, if any.

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.

Finance income and finance expenses are recognised by applying the effective interest rate, except for short-term receivable when the effect of discounting is immaterial.

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 years if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized.

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 year. 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 using the original discount rate when the future projections initially used to measure the obligations are revised. Resulting changes in the carrying amount of these obligations are recognized in the consolidated statement of income (loss) as finance income or finance expenses.

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.

Basic and Diluted Income (Loss) per Share

Basic income (loss) per share is calculated by dividing net income (loss) for the year attributable to equity owners of the Company by the weighted average number of common shares outstanding during the year (Note 16).

Diluted income (loss) per share is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The number of shares included with respect to options and similar instruments is computed 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.

Revenue recognition

The Company earns revenues mainly from the sale of natural gas dryers, air 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 and labour). 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 goods sold 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.

Government grants

Non-refundable grants relating to property, plant and equipment are accounted for as deferred government grants 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 consolidated statement of income (loss) on a straight-line basis over the lease term.

Leases 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 consolidated statement of loss over the lease year so as to produce a constant yearly rate of interest on the remaining balance of the liability for each year. 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 accounts for stock options using the fair value method. Each tranche in an award is considered a separate award with its own vesting year 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 during 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, share capital is credited by the sum of the consideration paid and the related amount 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. During the year ended December 31, 2017, development expenses related to development costs of a new line and engineering standardisation costs were deferred and accounted for as identified intangible asset.

Income taxes

Income tax comprises current and deferred tax. Income tax is recognized in the consolidated statement of loss except to the extent that it relates to items recognized directly in other comprehensive income or equity, in which case the income tax is also recognized directly as such.

Current income 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 year, and any adjustment to tax payable in respect of previous years.

In general, deferred income 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 income 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.

Foreign currency translation

Functional and presentation currency:

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

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 year (to the extent this is considered a reasonable approximation to actual rates). All resulting changes are recognized in other comprehensive income (loss) 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 (loss) 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 (loss) related to the subsidiary is reallocated between controlling and non-controlling interests.

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 consolidated statement of income (loss).

Segment reporting

The Company have many product lines classified into three segments according to the technology, the products functionalities and uses.

Clean Technology allows delivering of renewable gas for the production of fuel for a wide variety of applications, from fuel cells to the replacement of fossil fuels in transportation.

Industrial Compressed Air and Gas Treatment uses filtration technology to separate liquid droplets, particles or solid contaminants, and oil vapor out of air and gas flows. This segment distributes many types of Airdryers and provides OEM replacement parts and maintenance for aftermarket.

Oil and Gas segment focus on the commercialization of innovative membrane technology.

For management purposes, the Company uses the same measurement policies as those in its financial statements.

In addition, corporate assets are used by each segment and are therefore not attributable to any segment in particular.

Accounting standards issued but not yet applied that have relevance to the Company

The following standards have been issued but are not yet effective:

In May 2014, the IASB issued IFRS 15, “Revenues from Contracts with Customers”, to specify how and when to recognize revenue as well as requiring the provision of more information and relevant disclosure. IFRS 15 supersedes IAS 18, “Revenue”, IAS 11, “Construction Contracts”, and other revenue-related interpretations. The standard his mandatory since January 1, 2018. The Company has evaluated that there is no material impact of this standard on its consolidated financial statements.

In July 2014, the IASB amended IFRS 9, “Financial Instruments”, to bring together the classification and measurement, impairment and hedge accounting phases of the IASB’s project to replace IAS 39, “Financial Instruments: Recognition and Measurement”. The standard supersedes all previous versions of IFRS 9 and his mandatory since January 1, 2018. The Company has evaluated that there is no material impact of this standard on its consolidated financial statements.

In January 2016, IASB issued IFRS 16, “Leases”, which specifies how an IFRS reporter will recognize, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value. Lessors continue to classify leases as operating or finance, with IFRS 16’s approach to lessor accounting substantially unchanged from its predecessor, IAS 17. The standard will be mandatory for annual periods beginning on or after January 1, 2019. The Company is currently evaluating the impact of this standard on its consolidated financial statements.

4 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 affect the Company's consolidated financial statements.

i. Inventories must be valued at the lower of cost and net realizable value.

A writedown of 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 estimation process 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 goods sold.

ii. Impairment of internally generated intangible assets

The Company performs a test for internally generated intangible assets impairment when there is any indication that internally generated intangible assets have suffered any impairment in accordance with the accounting policy stated in the summary of significant accounting policies of these consolidated financial statements. The recoverable amounts of internally generated intangible assets have been determined based on value-in-use calculations. The value in use calculation is based on a discounted cash flow model. These calculations require the use of estimates and forecasts of future cash flows. Qualitative factors, including, degree of variability in cash flows as well as other factors are considered when making assumptions with regard to future cash flows and the appropriate discount rate. A change in any of the significant assumptions or estimates used to evaluate internally generated intangible assets could result in a material change to the results of operations.

iii. Percentage of completion and revenues from long-term production-type contracts

Revenues recognized on long-term production-type contracts reflect management's best assessment by taking into consideration all information available at the reporting date and the result on each ongoing contract and its estimated costs. The management assesses the profitability of the contract by applying important judgments regarding milestones marked, actual work performed and estimated costs to complete. Actual results could differ because of these unforeseen changes in the ongoing contracts' models.

(expressed in Canadian dollars)

iv. Allowance for doubtful accounts

The Company reviews all amounts periodically for indications of impairment and the amounts impaired have been provided for as an allowance for doubtful accounts.

v. Liquidity risk

The assessment of the Company's ability to continue as a going concern and to raise sufficient funds to pay for its ongoing operations expenditures, meets its liabilities for the ensuing year, involve significant judgment based on historical experience and other factors including expectation of future events that are believed to be reasonable under the circumstances.

5 Trade and other receivables

	2017 $	2016 $
Trade receivables	2,760,659	2,138,748
Other receivables	1,462,159	758,984
Less: Allowance for doubtful accounts	(89,559)	(448,291)
Trade and other receivables – net	4,133,259	2,449,441

Trade and other receivables are pledged as security for the credit facilities (see Notes 9 and 10).

6 Inventories

	2017 $	2016 $
Raw materials	1,381,780	896,484
Work in progress	581,612	433,032
Inventories	1,963,392	1,329,516

Cost of goods sold includes cost of inventories amounting to $5,153,437 in 2017 (2016 - $4,037,908). During the current year, a reversal of a previous inventory writedown amounting to $189,065 ($17,420 in 2016) was recognized in inventory as the Company deems these parts recoverable for future orders. Inventories are pledged as security for the credit facilities (see Notes 9 and 10).

(expressed in Canadian dollars)

7 Property, plant and equipment

	Machinery and equipment[1] $	Office furniture and equipment $	Computers[1] $	Moulds $	Vehicles $	Total $
Cost						
Balance at December 31, 2015	548,952	156,537	275,690	176,944	35,984	1,194,107
Additions	45,988	132	9,485	-	-	55,605
Effect of movements in exchange rates	(17,048)	(8,957)	(14,330)	(10,367)	-	(50,702)
Balance at December 31, 2016	577,892	147,712	270,845	166,577	35,984	1,199,010
Additions	5,431	6,951	13,728	-	-	26,110
Effect of movements in exchange rates	(3,192)	(1,761)	550	(103)	-	(4,506)
Balance at December 31, 2017	580,131	152,902	285,123	166,474	35,984	1,220,614
Accumulated depreciation						
Balance at December 31, 2015	342,427	127,067	245,528	120,706	35,984	871,712
Depreciation	50,011	10,427	16,933	17,414	-	94,785
Effect of movements in exchange rates	(10,700)	(8,588)	(13,011)	(9,726)	-	(42,025)
Balance at December 31, 2016	381,738	128,906	249,450	128,394	35,984	924,472
Depreciation	46,208	9,154	15,224	16,998	-	87,584
Effect of movements in exchange rates	(72)	(387)	510	(125)	-	(74)
Balance at December 31, 2017	427,874	137,673	265,184	145,267	35,984	1,011,982
Carrying Amount						
At December 31, 2016	196,154	18,806	21,395	38,183	-	274,538
At December 31, 2017	152,257	15,229	19,939	21,207	-	208,632

Depreciation of $87,584 (2016 – $94,785) is included in the consolidated statement of income (loss): $67,966 (2016 – $72,930) in cost of goods sold; and $19,618 (2016 – $21,855) in selling and administrative expenses.

Property, plant and equipment are pledged as security for the credit facilities (see Notes 9 and 10))

(1) including equipment under finance lease. The cost of equipment under finance lease amount to $54,294 ($45,988 in 2016) and the accumulated depreciation amount to $4,883 ($383 in 2016).

(expressed in Canadian dollars)

8 Intangible assets

	Other	Internally generated		
	Software $	Development costs $	Engineering standardisation $	Total intangible assets $
Cost				
Balance at December 31, 2015	313,653	298,485	-	612,138
Additions	28,404	490	-	28,894
Effect of movements in exchange rates	(14,865)	-	-	(14,865)
Balance at December 31, 2016	327,192	298,975	-	626,167
Additions	-	2,084	306,618	308,702
Effect of movements in exchange rates	10,203	-	-	10,203
Balance at December 31, 2017	337,395	301,059	306,618	945,072
Accumulated amortization				
Balance at December 31, 2015	282,618	88,737	-	371,355
Amortization for the year	17,140	59,697	-	76,837
Effect of movements in exchange rates	(12,768)	-	-	(12,768)
Balance at December 31, 2016	286,990	148,434	-	435,424
Amortization for the year	20,629	59,696	-	80,325
Effect of movements in exchange rates	10,927	33	-	10,960
Balance at December 31, 2017	318,546	208,163	-	526,709
Carrying amount				
At December 31, 2016	40,202	150,541	-	190,743
At December 31, 2017	18,849	92,896	306,618	418,363

Amortization of $80,325 (2016 – $76,837) is included in the consolidated statement of income (loss): $20,213 (2016 – $16,277) in cost of goods sold; and $60,112 (2016 – $60,560) in selling and administrative expenses.

(expressed in Canadian dollars)

9 Bank loan

The Company has access to credit facilities in the amount of $750,000 with Toronto-Dominion Bank of Canada which are guaranteed by Export Development Canada, and bear interest at the Toronto-Dominion's prime rate plus 3.0% (5.7% in 2016) per annum and are limited by certain margin requirements concerning trade and other receivables. These credit facilities were used up to nil as at December 31, 2017 (2016 – $755,000).

The credit facilities are secured by a first ranking hypothec of $5,000,000 on all movable property of the Company and are renewable annually.

The company has a guarantee facility of $750,000 with Toronto-Dominion Bank of Canada.

10 Credit Facility

On December 12, 2016, the Company contracted a facility loan with Export Development Canada ("EDC") for an amount of $2,000,000. This amount is available in four advances. The facility bears an interest of prime rate plus 6.3% (9.5%). This interest is payable every month. This amount shall be repaid based on the completion of certain project milestones.

The facility loan is secured by a second ranking hypothec in all present and future movable property of the Company.

The following table summarizes the activity related to the facility with EDC during the year ended December 31, 2017:

	2017 **$**	2016 $
Balance – January 1,	-	-
Addition	2,000,000	-
Repayment	(562,088)	-
Balance – December 31,	1,437,912	-

11 Trade, other payables and accrued liabilities

	2017 **$**	**2016** **$**
Trade payables	2,741,565	2,893,639
Accrued liabilities	723, 441	619,565
Payables to related parties (Note 25)	29,310	29,405
Other payables	91,439	80,650
Trade, other payables and accrued liabilities	3,585,755	3,623,259

(expressed in Canadian dollars)

12 Deferred revenue

	2017 $	2016 $
Deferred revenue on current contracts	720,996	942,575

13 Long-term debt

a) Loans

	2017 $	2016 $
Obligation under a capital lease, repayable in monthly installments of $1,607 including interest calculated at 13% maturing in October 2018, secured by equipment under finance lease.	18,669	42,120
Obligation under a capital lease, repayable in monthly installments of $352 including interest calculated at 12% maturing in September 2020, secured by equipment under finance lease.	10,475	-
Unsecured Convertible debentures	2,216,570	754,780
Long-term debt	2,245,714	796,900
Less: Current portion	22,236	22,112
	2,223,478	774,788

On November 16, 2017, the Company has completed an Unsecured Convertible Debentures ("Debentures") financing for aggregate gross proceeds of $2,024,149. The Debentures will reach maturity on November 15, 2019 and bearing an annual interest rate of 8%, convertible into common shares of the Company at a price of $0.65 per share. The unpaid interests are convertible at the highest price of $0.65 per common share or the fair value of the common share at the request of the debenture holder.

The Company used the residual value method to allocate the principal amount of the Debenture between the liability and the equity component. Under this method, the value of the equity component of $186,177 (net of deferred tax liability of $81,989) was determined by deducting the fair value of the liability component from the principal amount of the financing. The fair value of the liability component was $1,626,594 computes as the present value of future principal and interest payments discounted at a rate of 17.50%. The effective interest method is used to measure the Debenture after the initial recognition.

On November 30, 2016, the Company has completed an Unsecured Convertible Debentures ("Debentures") financing for aggregate gross proceeds of $1,000,000. The Debentures will reach maturity on November 30, 2019 and bearing an annual interest rate of 9%, convertible into common shares of the Company at a price of $0.15 per share. The unpaid interests are convertible at the highest price of $0.15 per common share or the fair value of the common share at the request of the debenture holder.

The Company used the residual value method to allocate the principal amount of the Debenture between the liability and the equity component. Under this method, the value of the equity component of $150,304 (net of deferred tax liability of $59,316) was determined by deducting the fair value of the liability component from the principal amount of the financing. The fair value of the liability component was $790,380 computes as the present value of future principal and interest payments discounted at a rate of 19.50%. The effective interest method is used to measure the Debenture after the initial recognition.

During the year, 2,000,000 common shares were issued as a result of the exercise of the conversion option by some of the debenture holders. The common shares issued included the carrying value of the liability component to the date of conversion. The conversion is a non-cash transaction and thus is excluded from the consolidated statement of cash flows.

(expressed in Canadian dollars)

b) Government royalty program obligation

In 2012, the Company signed a settlement agreement with Technology Partnership Canada (TPC) with regard to the Company's Fast Cycle Pressure Swing Adsorption and Gas Management systems and Pulsar Pressure Swing Adsorption project. The Company had to pay $250,000 at the execution of the agreement and $1,000,000 spread over four equal annual non-interest bearing payments, starting on January 31, 2013. Furthermore, the Company was liable to pay up to $750,000 in contingent payments based on proceeds from the sale by the Company of its intellectual property. Upon closing of the transaction, the Company paid $540,000 out of the $750,000 total contingent-based payments. On October 23, 2012, the Company accrued another $150,000 out of the $750,000 total contingent based payments, following additional proceeds received, leaving a potential maximum amount to be paid of $60,000 as at December 31, 2012.

In 2013, the Company realized the last milestone pursuant to the transaction and paid the remaining $60,000. The Company renegotiated its payments terms with TPC, changing from an annual payment of $250,000 to monthly payments of $24,500 but adding an extra year to term.

In February 2017, a new amendment to this agreement was reached changing the preceding payments terms from monthly payments of $24,500 to monthly payments of:

- $29,505 upon execution including interest
- $5,000 starting from March 1, 2017 to January 1, 2018
- $7,000 starting from February 1, 2018 to January 1, 2019
- $8,000 starting from February 1, 2019 to January 1, 2020
- $10,000 starting from February 1, 2020 to January 1, 2021
- $15,000 starting from February 1, 2021 to October 1, 2022
- $20,000 on November 1, 2022 and December 1, 2022
- And the balance of $22,540 on January 1, 2023.

The following table summarizes the activity related to the government royalty program obligation during the year ended December 31, 2017:

	2017 **$**	**2016** **$**
Balance – Beginning of year	757,540	724,041
Gain on revaluation of government royalty program	(117,095)	33,499
Accretion finance expenses	25,927	-
Repayment	(75,000)	-
Balance – End of year	591,372	757,540
Current portion	(86,826)	757,540
	504,546	-

(expressed in Canadian dollars)

The carrying amount of the government royalty program obligation has been calculated by discounting the future cash flows at a 5% interest rate.

14 Provisions

	Provision for contingencies	Warranty costs	Total provision
	$	**$**	**$**
At December 31, 2016	160,532	57,527	218,059
Used during the year	(160,532)	(35,237)	(195,769)
At December 31, 2017	-	22,290	22,290
Current portion of provision	-	16,689	16,689
Non-current provision	-	5,601	5,601

Warranty cost

The Company offers warranties 18 months after shipping or 12 months after start-up to the purchasers of its gas purification and natural gas dryers.

15 Obligation arising from shares issued by subsidiary

In September 2015, as a result of a Sino-foreign equity joint venture agreement, Xebec Adsorption (Shanghai) Co. Ltd., a subsidiary of Xebec Adsorption Inc. (“Xebec”), issued 1,714,285 common shares, representing a 30% participation, to Shanghai Chengyi New Energy Venture Capital Co. Ltd. (28.26%), an investment subsidiary of Shanghai based Shenergy Group, Shanghai Zhiyi Enterprise Management Consulting Co. Ltd. (0.1%) and Shanghai Liuhuan Investment Co. Ltd. (1.64%), a company held by a group of employees of Xebec Adsorption (Shanghai) Co. Ltd., (collectively the “Minority Shareholders”) for a net cash consideration of $3,423,075 (RMB 16,370,515).

(expressed in Canadian dollars)

Pursuant to this agreement, Xebec has the obligation to repurchase the Minority Shareholders' interest in Xebec Adsorption (Shanghai) Co. Ltd., for a consideration of no less than the initial investment and annualized return of 10% if a) the achievement of specific financial targets were not achieved in any given year prior to December 31, 2020, or b) should the Minority Shareholders not divest by December 31, 2020 and should the Minority Shareholders exercise their put option with respect to a) or b) as mentioned above.

Xebec recorded the proceeds from this transaction, as a financial liability in these consolidated financial statements. The obligation to repurchase and the related annualized return is presented under "Obligation arising from shares issued by a subsidiary". The conversion of the financial liability denominated in the functional currency of our subsidiary Xebec Adsorption (Shanghai) Co. Ltd. (RMB) will be converted at the exchange rate at the end of each reporting period with gain and losses presented in the statement of income (loss) under "Gain/Loss on conversion of shares issued by a subsidiary".

	2017 **$**	**2016** **$**
Balance – Beginning of year	3,582,135	3,583,808
Accretion interest	332,537	350,575
Effect of exchange rate change on obligation	(2,358)	(352,248)
Balance – End of year	3,912,314	3,582,135

(expressed in Canadian dollars)

Share capital

a) The Company is incorporated under the Canada Business Corporations Act, and its authorized share capital consists of an unlimited number of common shares, without par value.

b) Share purchase warrants

There were no warrants issued in 2017 and 2016.

c) Income (loss) per share

i) Basic

Basic income (loss) per share is calculated using net income (loss) as the numerator and the weighted average number of shares as denominator. No adjustments to net income were necessary in 2017 and 2016.

ii) Diluted

For the year ended December 31, 2017, convertible debentures and outstanding stock options with an average exercise price of over $0.40 would have been anti-dilutive.

For the year ended December 31, 2016, convertible debentures and outstanding stocks options would have been anti-dilutive.

The reconciliation of the weighted average number of shares for the purpose of diluted income per share to the weighted average number of shares used in the calculation of basic income per share is as follows:

	2017	**2016**
Weighted average number of shares used in basic income per share	40,562,060	39,363,867
Shares deemed to be issued for no consideration in respect of share-based payments	4,674,896	-
Weighted average number of shares used in diluted income per share	45,236,956	39,363,867

(expressed in Canadian dollars)

17 Stock options

The stock option plan allowed for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards and other stock-based awards. Under the Plan, a fixed number of 7,892,773 common shares are available for grant. As at December 31, 2017, the maximum number of common shares available for issuance under all stock-based compensation arrangements is 63,743

Under the terms of the Xebec Adsorption Stock Option 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. The terms and conditions for acquiring and exercising options are set by the Board of Directors. Stock options for employees vest no less than at grant date and no more than quarterly.

Stock option activity for the years ended December 31, is presented below:

		2017		**2016**
	Number of options	**Weighted average exercise price $**	**Number of options**	**Weighted average exercise price $**
Outstanding – Beginning of year	5,855,337	0.11	4,390,337	0.16
Granted	3,119,193	0.20	1,500,000	0.05
Exercised	(1,140,500)	0.05	-	-
Cancelled	(5,000)	0.22	(25,000)	7.29
Expired	-	-	(10,000)	0.22
Outstanding – End of year	7,829,030	0.19	5,855,337	0.11
Exercisable – End of year	5,804,837	0.13	5,855,337	0.11

(expressed in Canadian dollars)

As at December 31, 2017, options outstanding and exercisable are as follows:

Expiry date	Weighted-Average Exercise Price	Number of Options Outstanding	Weighted-Average Remaining life	Number of Options exercisable
August 11, 2018	$0.22	232,272	0.6	232,272
December 22, 2018	$0.10	1,519,500	1.0	1,519,500
June 12, 2020	$0.16	258,065	2.4	258,065
April 25, 2021	$0.15	100,000	3.3	100,000
May 29, 2021	$0.14	200,000	3.4	200,000
September 22, 2021	$0.12	2,000,000	3.7	2,000,000
December 19, 2022	$0.55	400,000	5.0	-
January 8, 2023	$0.05	400,000	5.0	400,000
March 5, 2024	$0.18	2,108,193	6.2	1,095,000
August 29, 2024	$0.49	500,000	6.7	-
December 19, 2024	$0.55	111,000	7.0	-
	$0.19	**7,829,030**	**4.1**	**5,804,837**

As at December 31, 2016, options outstanding and exercisable are as follows:

	Options outstanding			Options exercisable	
Exercise price range $	**Number of options**	**Weighted average remaining contractual life (years)**	**Weighted average exercise price $**	**Number of options**	**Weighted average exercise price $**
0.05 – 0.10	3,060,000	3.96	0.08	3,060,000	0.08
0.12 – 0.16	2,558,065	4.34	0.13	2,558,065	0.13
0.22	237,272	1.61	0.22	237,272	0.22
	5,855,337	4.03	0.11	5,855,337	0.11

On March 5, 2017, the Company granted 2,108,193 stock options to directors, officers and employees. The options are exercisable at $0.18 per share, and expire on March 5, 2024. The options are subject to vesting criteria such that 1,095,000 shall vest on the grant date, 795,000 shall vest on March 5, 2018 and 218,193 shall vest on March 5, 2019. The grant of these stock options was conditional to the approval of the increase of the pool of the stock options of the Company by the shareholders at the Annual General Meeting and the TSX Venture Exchange. These approvals were obtained respectively on June 15, 2017 and August 9, 2017. The corresponding stock-based compensation amounted to $354,118, which was estimated using the Black-Scholes Option Pricing Model with the following assumptions:

(expressed in Canadian dollars)

Risk-free interest rate	1.55%
Annualized volatility[1]	137%
Share price	$0.18
Dividend rate	0.00%
Expected life of options	7 years

On August 29, 2017, the Company granted 500,000 stock options to an employee. The options are exercisable at $0.49 per share, and expire on August 29, 2024. The options are subject to vesting criteria such that 20% shall vest on the first anniversary date and 20% shall vest every twelve months thereafter. The corresponding stock-based compensation amounted to $227,026, which was estimated using the Black-Scholes Option Pricing Model with the following assumptions:

Risk-free interest rate	1.80%
Annualized volatility[1]	138%
Share price	$0.49
Dividend rate	0.00%
Expected life of options	7 years

On December 19, 2017, the Company granted 511,000 stock options to directors. The options are exercisable at $0.55 per share. 400,000 expire on December 19, 2022 and 111,000 expire on December 19, 2024. The options are subject to vesting criteria such that 33% shall vest on the first anniversary date and 33% shall vest every twelve months thereafter. The corresponding stock-based compensation amounted to $252,250, which was estimated using the Black-Scholes Option Pricing Model with the following assumptions:

Risk-free interest rate	1.57%
Annualized volatility[1]	140%
Share price	$0.55
Dividend rate	0.00%
Expected life of options	5 years

and,

[1] The expected volatility used was based on the historic volatility of the Company share price

(expressed in Canadian dollars)

Risk-free interest rate	1.77%
Annualized volatility[1]	*138%*
Share price	$0.55
Dividend rate	0.00%
Expected life of options	7 years

In 2016, 1,100,000 options were granted to employees at weighted average fair value of $0.05 and 400,000 options were granted to non-employees at a weighted average fair value of $0.05.

During the year, the Company expensed $372,603 (2016 – $71,242) which totally relates to stock options granted in 2017.

18 Expenses by nature

	2017 **$**	**2016** **$**
Employee salaries and benefits	5,521,600	5,062,355
Material	5,457,118	4,037,908
Subcontract cost	867,993	274,235
Professional fees	818,272	473,566
Rent and repairs and maintenance	700,393	669,899
Travel expenses	658,667	525,420
Stock-based compensation	372,603	71,242
Office expense	239,660	280,466
Amortization and depreciation	167,908	171,622
Other	17,951	131,658
Bad Debt	(8,873)	75,995
Reversal of trade payables	(303,363)	-
Reversal of allowance for doubtful accounts	(315,145)	-
	14,194,784	11,774,366

(expressed in Canadian dollars)

19 Research and development expenses

	2017 $	2016 $
Employee salaries and benefits	25,212	129,432
Material	23,884	8,983
Subcontracting costs	11,844	(44,229)
Professional fees	10,848	59,476
Travel expenses	502	368
Government grants	(2,083)	(5,000)
Research and development tax credits	(29,663)	(6,334)
Reversal of trade payables	(71,658)	-
	(31,114)	142,696

20 Finance expenses

	2017 $	2016 $
Accretion of the obligation arising from shares issued by a subsidiary (Note 15)	332,537	350,575
Interest on convertible debentures	197,228	16,327
Interest and bank charges	191 093	143,515
Interest on short term debt	186,802	-
Accretion and revaluation of government royalty program obligation (Note 13b))	25 927	33,499
Interest on long term debt	203	-
Reversal of trade payables	(322,638)	-
	611,152	543,916

(expressed in Canadian dollars)

21 Compensation of key management

Compensation awarded to key management included:

	2017 $	2016 $
Salaries and short-term employee benefits	1,256,164	966,834
Stock-based compensation	318,922	71,242
	1,575,086	1,038,076

Key management included the Company's senior management and members of the Board of Directors.

22 Income taxes

Effective tax rate

The income tax expense attributable to earnings differs from the amounts computed by applying the combined federal and provincial income tax rate of 26,8% (26.9 in December 31, 2016) to earnings before income taxes as a result of the follow:

	2017 $	2016 $
Income (loss) before income taxes	96,752	(2,671,442)
Expected income tax recovery	25,930	(718,618)
Tax expense at combines statutory rate Increase (decrease) in income taxes resulting from :		
Temporary difference unrecognized (recognized)	(412,952)	206,432
Difference in foreign tax rate	(19,557)	23,043
Stock base compensation	99,858	19,164
Change of deferred tax rates	108,285	337,351
Foreign exchange on consolidation	854	4,639
Expired losses	67,007	36,663
Other	130,575	32,190
	-	(59,136)

(expressed in Canadian dollars)

Composition of deferred income taxes in the Consolidated Statements of Income (Loss)

	2017 **$**	**2016** **$**
Inception and reversal of temporary differences	304,667	(602,919)
Temporary difference not recorded	(412,952)	206,432
Change in deferred tax rate	108,285	337,351
	-	(59,136)

Movement of deferred income tax in 2017

	January 1, 2017 **$**	**P&L**	**Equity Component**	**December 31, 2017** **$**
Contingency reserve	-	(81,989)	-	(81,989)
Intangibles assets	-	(49,974)	-	(49,974)
Debentures	(53,975)	37,143	(81,989)	(98,821)
Government royalty program	-	(24,160)	-	(24,160)
Non capital losses	53,975	118,980	-	172,955
	-	-	(81,989)	(81,989)

Movement of deferred income tax in 2016

	January 1, 2016 **$**	**P&L**	**Equity Component**	**December 31, 2016** **$**
Debentures	-	5,161	(59,136)	(53,975)
Non capital losses	-	53,975	-	53,975
	-	59,136	(59,136)	-

(expressed in Canadian dollars)

As at December 31, 2017, deductible timing differences for which the company has not recognized deferred tax asset are as follows:

	Federal $	Quebec $	Chine $	USA $
Property and equipment	995,217	995,217	-	-
Scientific research and development expenses	24,583,744	24,587,643	-	-
Capital losses carried forward	219,247	219,247	-	-
Operating losses carried forward	54,175,945	56,733,006	1,434,206	708,665
Other	688,795	688,795	-	-
	80,662,948	83,223,908	1,434,206	708,665

The ability to realize the tax benefits is dependent upon a number of factors, including the future profitability of operations. Deferred tax assets are recognized only to the extent that it is probable that sufficient taxable profits will be available to allow the asset to be recovered. Accordingly, some deferred tax assets have not been recognized, these deferred tax assets not recognized equal an amount of $ 22,191,258 ($22,597,127 in 2016).

As at December 31, 2016, deductible timing differences for which the company has not recognized deferred tax asset are as follows:

	Federal $	Quebec $	Chine $	USA $
Property and equipment	938,985	938,985		
Intangible assets	59,079	59,079		
Scientific research and development expenses	24,502,892	24,500,175		
Capital losses carried forward	219,247	219,247		
Operating losses carried forward	55,350,875	57,925,868		
Other	694,496	694,496	1,783,721	493,442
	81,765,574	84,337,850	1,783,721	493,442

(expressed in Canadian dollars)

As at December 31, 2017, the Company has non-capital tax losses, which are available to reduce taxes in futures years and expired as follows:

	Federal $	**Quebec** $	**China** $	**USA** $
2037	-	-	-	247,637
2036	1,486,941	1,480,325	-	-
2035	1,328,532	1,328,532	-	461,028
2034	-	2,635,090	-	-
2033	326,251	326,251	-	-
2032	546,237	494,621	-	-
2031	443,287	433,086	-	-
2030	12,361,610	12,361,610	-	-
2029	7,283,831	7,295,856	-	-
2028	10,824,277	10,824,277	-	-
2027	6,794,635	6,794,635	-	-
2026	7,229,354	7,229,354	-	-
2025	5,550,990	5,529,369	-	-
2024	-	-	-	-
2023	-	-	-	-
2022	-	-	-	-
2021	-	-	884,551	-
2020	-	-	-	-
2019	-	-	-	-
2018	-	-	549,655	-
	54,175,945	56,733,006	1,434,206	708,665

The Company has scientific research and experimental development expenses of $24,583,744 (2016 – $24,502,892) which are available to be carried forward indefinitely and deducted against future taxable income otherwise calculated. The potential benefit has not been recorded in the accounts.

As at December 31, 2017, the Company also has investment tax credits of $5,678,183 (2016 – $5,659,361) available to offset future Canadian federal income taxes payable. The potential benefit of the investment tax credits has not been recognized in the accounts.

(expressed in Canadian dollars)

23 Supplemental Cash flow information

Net change in non-cash working capital balances related to operations consists of the following:

	2017 $	2016 $
Decrease (increase) in assets:		
Trade and other receivables	(1,368,673)	(12,282)
Inventories	(444,811)	(170,256)
Investment tax credits receivable	32,010	69,723
Other current assets	(71,861)	(29,441)
Increase (decrease) in liabilities:		
Trade payables, other payables and accrued liabilities	660,157	(256,911)
Deferred revenues	(221,579)	244,014
Provisions and deferred rent	(195,769)	(500,514)
	(1,610,526)	(655,667)

24 Commitments

Following is a summary of Xebec's contractual obligations and commitments:

As at December 31, 2017	**Payment Due by Period**			
	1 year	2 - 5 years	Beyond 5 years	Total
	$	$	$	$
Operating leases	491,577	1,307,019	1,605,711	3,404,307

Operating leases include one building in Blainville, Quebec, and various equipment leases. The operating leases expenses for the year ended December 31, 2017 amounted to $ 440,519 (S480,027 in 2016)

(expressed in Canadian dollars)

25 Related party transactions

The following table presents a summary of the related party transactions during the period:

	2017 $	2016 $
Marketing and professional services expenses paid to companies controlled by members of the immediate family of an officer	158,900	111,796

These transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

26 Capital management

The Company's objective when managing capital is to use short-term funding sources to manage its working capital requirements and fund capital expenditures required to execute its operating and strategic plans.

The Company's capital structure is composed of the following:

	2017 $	2016 $
Cash	(1,341,121)	(1,088,592)
Bank loan	-	755,000
Credit facility	1,437,912	-
Long-term debt	2,245,714	796,900
Government royalty program obligation (Note 13 b))	591,372	757,540
Obligation arising from shares issued by a subsidiary (Note 15)	3,912,314	3,582,135
	6,846,191	4,802,983
Equity	(4,390,290)	(5,246,987)
	2,455,901	(444,004)

The Company is not subject to any capital requirements imposed by regulators.

(expressed in Canadian dollars)

27 Segmented information

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

	2017 $	2016 $
Revenue		
United States	4,284,624	4,022,932
France	4,022,726	-
Canada	2,918,138	2,397,870
China	2,405,773	847,323
Singapore	112,501	739,826
Other	1,002,169	1,579,430
	14,745,931	9,587,381

Sales of $2,417,498 ($ 991,712 in 2016) arose from the Company's largest customer. No other single customer contributed more than 10 % to the company's revenue for both 2017 and 2016.

Income (loss) summarized by business segments are as follows:

As of December 31, 2017

	Clean Technology	Industrial Compressed Air and Gas treatment	Oil and gas Processing	Corporate	Total
	$	$	$	$	$
Revenue	8,902,695	4,457,380	1,385,856	-	14,745,931
Cost of goods sold	6,180,724	2,794,488	2,497	-	8,977,709
Gross margin	2,721,971	1,662,892	1,383,359	-	5,768,222
Gross margin %	31%	37%	100%	0%	39%
Research and development expenses	(31,114)	-	-	-	(31,114)
Selling and administrative expenses	933,784	805,745	285,775	3,191,771	5,217,075
Insurance compensation for damage to inventories	-	-	-	(132,366)	(132,366)
Foreign exchange loss (gain)	-	-	-	131,149	131,149
Gain on conversion of shares issued by a subsidiary	-	-	-	(2,358)	(2,358)
Finance income	-	-	-	(122,068)	(122,068)
Finance expenses	-	-	-	611,152	611,152
Total expenses	902,670	805,745	285,775	3,677,280	5,671,470
Segment income (loss)	1,819,301	857,147	1,097,584	(3,677,280)	96,752

(expressed in Canadian dollars)

As of December 31, 2016

	Clean Technology	Industrial Compressed Air and Gas treatment	Oil and gas Processing	Corporate	Total
	$	$	$	$	$
Revenue	4,809,731	4,777,650	-	-	9,587,381
Cost of goods sold	4,481,318	2,938,409	-	-	7,419,727
Gross margin	328,413	1,839,241	-	-	2,167,654
Gross margin %	7%	38%	0%	0%	23%
Research and development expenses	142,696	-	-	-	142,696
Selling and administrative expenses	647,628	690,430	-	3,016,581	4,354,639
Foreign exchange loss	-	-	-	213,303	213,303
Gain on conversion of shares issued by a subsidiary	-	-	-	(352,248)	(352,248)
Finance income	-	-	-	(3,893)	(3,893)
Finance expenses	-	-	-	543,916	543,916
Income taxes	-	-	-	-	(59,316)
Total expenses	790,324	690,430	-	3,417,659	4,839,097
Segment income (loss)	(461,911)	1,148,811	-	(3,417,659)	(2,671,443)

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

	2017 $	2016 $
Non-current assets		
Canada	520,491	305,071
Asia	66,570	111,480
United States	39,934	48,730
	626,995	465,281

(expressed in Canadian dollars)

28 Financial instruments

a. Measurement categories and fair values, including valuation methods and assumptions

The following tables show the carrying values and fair values of assets and liabilities by category as of:

December 31, 2017	Loans and receivables		Other financial liabilities	
	Carrying amount $	Fair value $	Carrying amount $	Fair value $
Cash	1,341,121	1,341,121	-	-
Trade and other receivables	3,094,761	3,094,761	-	-
Other current assets	13,500	13,500	-	-
Credit facility	-	-	1,437,912	1,437,912
Trade, other payables and accrued liabilities	-	-	3,032,213	3,032,213
Convertible debentures	-	-	2,216,570	2,216,570
Government royalty program obligation	-	-	591,372	591,372
Obligation arising from shares issued by a subsidiary	-	-	3,912,314	3,912,314

(expressed in Canadian dollars)

December 31, 2016

	Loans and receivables		Financial liabilities	
	Carrying amount $	**Fair value $**	**Carrying amount $**	**Fair value $**
Cash	1,088,592	1,088,592	-	-
Trade and other receivables	1,743,353	1,743,353	-	-
Other current assets	15,850	15,850	-	-
Bank loan	-	-	755,000	755,000
Trade, other payables and accrued liabilities	-	-	3,118,064	3,118,064
Convertible debentures	-	-	754,780	754,780
Government royalty program obligation	-	-	757,540	757,540
Obligation arising from shares issued by a subsidiary	-	-	3,582,135	3,582,135

The carrying values of cash, trade and other receivables, trade and other payables, accrued liabilities, bank loan and credit facility approximate their fair value due to their short-term maturities. The methods and assumptions used in estimating the fair values of other financial assets and financial liabilities are as follows:

- Convertible debentures (classified in level 2 of the fair value hierarchy): The Company's convertible debentures carries fixed interest rates. The fair value of the Company's debt obligations has been calculated by discounting the future cash flows of the long-term debt at the interest rate of similar debt instruments.

- Government royalty program obligation (classified in level 2 of the fair value hierarchy): Fair value of the government royalty program obligation has been calculated by discounting the future cash flows at the interest rate for a similar loan in the market.

- Obligation arising from shares issued by a subsidiary (classified in level 2 of the fair value hierarchy): Fair value of the obligation arising from shares issued by a subsidiary has been calculated by computing an annualized return of 10% on the initial consideration

- The Company's financial instruments that are measured subsequent to initial recognition at fair value and financial instruments measured at amortized cost for which the fair value is disclosed are grouped into Levels 1 to 3 based on the degree to which the fair value is observable:

  Level 1 — Fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.

(expressed in Canadian dollars)

Level 2 — Fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3 — Fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

b. Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party fails to meet its contractual obligations. The Company's primary credit risk is its cash and outstanding trade and other receivables. The carrying amount of its outstanding trade and other receivables represents the Company's estimate of its maximum credit exposure. The Company regularly monitors its credit risk exposure and takes steps such as employing credit-approval procedures, establishing credit limits, using credit assessments and monitoring practices to mitigate the likelihood of these exposures from resulting in an actual loss. An allowance for doubtful accounts amounting to $89,559 (2016 – $448,291) was established based on prior experience and an assessment of current financial conditions of customers as well as the general economic environment. In cases where an allowance for doubtful accounts provision is recorded and a receivable balance is considered uncollectible, it is written off against the allowance for doubtful accounts. Bad debt recovery amounted to $324,018 in 2017 (expense in 2016 – $75,995). As at December 31, 2017, the Company's three largest trade debtors accounted for 29% (13%, 9% and 7%) of the total trade and receivables balance (2016 – 33% (13%, 10% and 10%)).

Details of trade and other receivables were as follows:

	2017 **$**	**2016** **$**
Current trade receivables	838,415	987,000
Trade receivables past due by:		
1–30 days	470,099	159,745
31–60 days	277,461	205,948
61–90 days	327,850	102,154
Over 90 days	846,834	683,901
Total trade receivables	2,760,659	2,138,748
Allowance for doubtful accounts	(89,559)	(448,291)
Other receivables	1,462,159	758,984
Total trade and other receivable	4,133,259	2,449,441

The following table summarizes the changes in the allowance for doubtful accounts for trade and other receivables:

	2017 $	2016 $
At beginning of period	(448,291)	(412,833)
Reversal of allowance for doubtful accounts (provision for impairment)	324,018	(75,995)
Unused amounts reserved	34,714	40,537
At ending of period	(89,559)	(448,291)

The Company's cash is maintained at financial institutions with high credit ratings; therefore, the Company considers the risk of non-performance on this instrument to be remote. To date, the Company has not incurred any losses related to its cash.

c. Market risk

i. Currency risk

Certain financial assets and financial liabilities are exposed to foreign exchange fluctuations. Taking into account the amounts denominated in the currencies indicated below and assuming that all of the other variables remain unchanged, a fluctuation in exchanges rates would have an impact on the Company's net income (loss). Management believes that a 10% change in exchange rates would be reasonably possible and that the impact on net income (loss) of such a change would be approximately $129,964 for 2017 (2016 – $113,473). As at December 31, 2017, the following accounts are shown in their original currencies and converted into Canadian dollars. The Company does not use financial instruments to reduce this risk.

	2017	
	US dollar	**Euro**
Cash	169,728	10,216
Trade and other receivables	612,994	-
Trade and other payables	345,659	(130,472)
	1,128,381	(120,256)
Equivalent in Canadian dollars	1,415,554	(181,010)

	2016	
	US dollar	**Euro**
Cash	604,037	135
Trade and other receivables	434,461	39,280
Trade and other payables	(114,296)	(114,365)
	924,202	(74,950)
Equivalent in Canadian dollars	1,240,926	(106,196)

ii. 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 loan and credit facility, for which the interest rates charged fluctuate based on the bank's prime rate. As at December 31, 2017, the short-term bank loan and credit facility amounted to $1,437,912 (2016 – $755,000). If the interest rate on the bank loan and credit facility had been 50 basis points higher (lower), related to the bank loan and credit facility as at December 31, 2017, net income would have been $11,218 (2016 – $3,295) lower (higher).

(expressed in Canadian dollars)

d. **Liquidity risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due.

The following are the contractual maturities of financial liabilities as at December 31:

					2017
	Carrying amount $	**Contractual cash flow $**	**0 to 12 months $**	**13 to 24 months $**	**Thereafter $**
Financial liabilities					
Credit facility	1,437,912	1,535,939	1,535,939	-	-
Trade and other payables and accrued liabilities	3,032,213	3,032,213	3,032,213	-	-
Government royalty program obligation	591,372	682,540	82,000	95,000	505,540
Obligation under capital lease	29,144	31,261	23,878	4,219	3,164
Convertible debentures	2,216,570	3,173,569	231,143	2,942,426	
Obligation arising from shares issued by a subsidiary	3,912,314	3,912,314	-	-	3,912,314
	11,219,525	12,269,809	4,807,146	3,041,645	4,421,018

					2016
	Carrying amount $	**Contractual cash flow $**	**0 to 12 months $**	**13 to 24 months $**	**Thereafter $**
Financial liabilities					
Bank loan	755,000	755,000	755,000	-	-
Trade and other payables and accrued liabilities	3,118,064	3,118,064	3,118,064	-	-
Government royalty program obligation	757,540	757,540	757,540	-	-
Obligation under capital lease	42,120	38,561	19,281	16,067	-
Convertible debentures	754,780	1,270,247	90,247	90,000	1,090,000
Obligation arising from shares issued by a subsidiary	3,582,135	3,582,135	-	-	3,582,135
	9,009,639	9,521,547	4,740,132	106,067	4,672,135

Contractual interest amounts on floating interest rates are established based on the spot rates as at the statement of financial position dates.

The Company's development is financed through a combination of borrowing under the existing credit facilities and the issuance of debt and equity (Note 1).