Xebec Adsorption Inc.

Interim Consolidated Financial Statements
(Unaudited)
June 30, 2010

Xebec Adsorption Inc.

Interim Consolidated Balance Sheet
(Unaudited)

	As at June 30, 2010 $	As at December 31, 2009 $
Assets		
Current assets		
Cash	2,258,946	5,447,702
Accounts receivable	2,305,015	3,105,834
Inventories	3,134,305	2,867,922
Prepaid expenses	170,916	183,564
Income taxes recoverable	29,855	62,492
Investment tax credits receivable	65,217	80,843
Restricted cash	206,461	223,261
Current portion of loan to a joint venture	57,716	37,777
	8,228,431	12,009,395
Loan to a joint venture, bearing interest at 7.93%, repayable by minimum annual instalments of $79,940 plus accrued and unpaid interest, maturing on July 1, 2012	57,716	75,554
Property, plant and equipment	2,358,841	2,604,931
Intangible assets (note 6)	4,459,990	279,046
Goodwill (notes 5 and 6)	1,438,324	5,942,152
	16,543,302	20,911,078
Liabilities		
Current liabilities		
Bank loan	496,900	496,900
Accounts payable and accrued liabilities	6,020,200	5,578,505
Deferred revenues	1,567,856	146,228
Derivative financial instruments	-	96,645
Current portion of long-term debt	309,941	321,653
Current portion of subordinated loan	62,496	62,496
	8,457,393	6,702,427
Long-term debt	1,794,900	1,763,496
Government assistance	34,583	37,083
Subordinated loan	125,008	156,256
	10,411,884	8,659,262
Shareholders' Equity		
Share capital	17,950,164	17,942,821
Contributed surplus	229,553	216,368
Deficit	(12,048,299)	(5,907,373)
	6,131,418	12,251,816
	16,543,302	20,911,078

See notes to interim consolidated financial statements.

Approved by the Board of Directors

_______________________ Director _______________________ Director

Xebec Adsorption Inc.

Interim Consolidated Statement of Loss and Comprehensive Loss
(Unaudited)

	For the three-month period ended June 30,		For the six-month period ended June 30,	
	2010 **$**	**2009** **$**	**2010** **$**	**2009** **$**
Revenue	4,141,617	4,303,256	6,133,267	9,010,635
Cost of goods sold (note 5)	3,743,238	2,732,013	5,413,281	5,552,752
Gross margin	398,379	1,571,243	719,986	3,457,883
Operating expenses				
Selling and administrative	2,621,952	1,861,076	5,109,123	3,232,924
Research and development (note 8)	578,224	125,727	1,121,116	199,474
Financial	123,299	46,950	214,409	116,430
Foreign exchange loss (gain)	(118,999)	213,257	45,936	202,158
Amortization	155,618	105,085	370,328	187,469
	3,360,094	2,352,095	6,860,912	3,938,455
Loss before income taxes	(2,961,715)	(780,852)	(6,140,926)	(480,572)
Provision for (recovery of) income taxes				
Current	-	(32,598)	-	12,402
Future	-	(71,017)	-	(10,415)
	-	(103,615)	-	1,987
Net loss and comprehensive loss for the period	(2,961,715)	(677,237)	(6,140,926)	(482,559)
Net loss per share				
Basic and diluted	(0.10)	(0.06)	(0.21)	(0.05)

See notes to interim consolidated financial statements.

Xebec Adsorption Inc.

Interim Consolidated Statement of Retained Earnings (Deficit)

(Unaudited)

For the six-month period ended June 30, 2010

	Number			Amount				
	Warrants	**Common shares**	**Preferred shares**	**Common shares and warrants $**	**Preferred shares $**	**Contributed surplus $**	**Retained earnings (deficit) $**	**Total $**
Balance – January 1, 2009	5,868,108	8,638,496	300,000	100	300,000	-	825,041	1,125,141
Net loss for the period	-	-	-	-	-	-	(482,559)	(482,559)
Conversion of preferred shares*	311,892	769,231	(300,000)	300,000	(300,000)	-	-	-
Deemed issuance of shares and warrants on reverse takeover transaction	6,180,000	11,269,318	-	11,921,423	-	26,767	-	11,948,190
Balance – June 30, 2009	12,360,000	20,677,045	-	12,221,523	-	26,767	342,482	12,590,772
Net loss for the period	-	-	-	-	-	-	(6,249,855)	(6,249,855)
Issuance of shares and warrants – Private placement, November 25, 2009	4,807,824	8,585,400	-	6,439,050	-	-	-	6,439,050
Financing costs – Private placement, November 25, 2009	-	-	-	(717,752)	-	165,000	-	(552,752)
Stock-based compensation	-	-	-	-	-	24,601	-	24,601
Balance – December 31, 2009	17,167,824	29,262,445	-	17,942,821	-	216,368	(5,907,373)	12,251,816
Net loss for the period	-	-	-	-	-	-	(6,140,926)	(6,140,926)
Issuance of shares	(9,536)	9,536	-	7,343	-	-	-	7,343
Stock-based compensation	-	-	-	-	-	13,185	-	13,185
Balance – June 30, 2010	17,158,288	29,271,981	-	17,950,164	-	229,553	(12,048,299)	6,131,418

* These represent the shares and warrants issued to the shareholders of Xebec on reverse takeover.

See notes to interim consolidated financial statements.

Xebec Adsorption Inc.

Interim Consolidated Statement of Cash Flows
(Unaudited)

	For the three-month period ended June 30,		For the six-month period ended June 30,	
	2010 $	2009 $	2010 $	2009 $
Cash flows from				
Operating activities				
Net loss for the period	(2,961,715)	(677,237)	(6,140,926)	(482,559)
Items not affecting cash				
Purchase price allocation adjustment (note 5)	303,066	-	303,066	-
Amortization of property, plant and equipment	142,514	89,743	341,272	157,895
Amortization of intangible assets	13,104	15,342	29,056	29,574
Unrealized foreign exchange loss (gain) on derivative financial assets	(172,963)	157,770	(96,645)	138,192
Unrealized foreign exchange loss (gain) on loan to joint venture and restricted cash	(4,543)	5,316	14,699	9,640
Stock-based compensation expense	6,587	243,030	13,185	243,030
Future income taxes	-	(71,017)	-	(10,415)
	(2,673,950)	(237,053)	(5,536,293)	85,357
Changes in non-cash working capital components relating to operations				
Accounts receivable	(476,006)	521,848	800,819	1,940,426
Inventories	(80,659)	(911,948)	(266,383)	(495,026)
Prepaid expenses	21,721	(158,850)	12,648	(76,196)
Investment tax credits receivable	-	192,204	15,626	127,508
Accounts payable and accrued liabilities	1,035,510	1,596,196	432,457	(48,954)
Deferred revenues	(603,064)	(9,154)	1,421,628	355,325
Income taxes	-	(288,388)	32,637	(250,515)
	(102,498)	941,908	2,449,432	1,552,568
	(2,776,448)	704,855	(3,086,861)	1,637,925
Investing activities				
Acquisition of property, plant and equipment	(87,884)	(10,277)	(95,182)	(173,274)
Acquisition of intangible assets	-	-	-	(4,598)
Transaction costs paid on acquisition of a business	-	(863,888)	-	(1,068,076)
Cash acquired on acquisition of a business	-	5,122,028	-	5,122,028
Government assistance	(1,250)	-	(2,500)	(1,250)
	(89,134)	4,247,863	(97,682)	3,874,830
Financing activities				
Issuance of common shares	7,343	-	7,343	-
Increase (decrease) in bank loan	9,208	(245,533)	-	(1,105,563)
Long-term debt	81,234	-	181,101	25,007
Repayment of long-term debt	(105,324)	(54,300)	(192,657)	(124,200)
Payment of obligations under capital leases	-	(3,211)	-	(6,359)
Decrease in restricted cash	-	75,000	-	75,000
	(7,539)	(228,044)	(4,213)	(1,136,115)
Increase (decrease) in cash during the period	(2,873,121)	4,724,674	(3,188,756)	4,376,640
Cash – Beginning of period	5,132,067	202,343	5,447,702	550,377
Cash – End of period	2,258,946	4,927,017	2,258,946	4,927,017

See notes to interim consolidated financial statements.

1 Nature of business and liquidity risk

a) Xebec Adsorption Inc. (the “Company”) is a provider specialized in the design, engineering and manufacturing of innovative gas solutions and services in the process of transforming raw gases into marketable sources of clean energy mainly used as transportation fuel. It results from the amalgamation of Xebec Adsorption Inc. (“Xebec”) and QuestAir Technologies Inc. (“QuestAir”) on June 12, 2009. The comparative financial statements are those of Xebec and the financial statements include the accounts of QuestAir from June 12, 2009 (note 5).

b) Liquidity risk

Although the Company has incurred an operating loss of $6,140,926 and had cash outflows from operations of $3,086,861 for the six-month period ended June 30, 2010, it finished the period with cash amounting to $2,258,946 and had access to unused credit facilities totalling $966,000. 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 projections for the 12-month period ending June 30, 2011 for which management believes the assumptions are reasonable. Achieving its projections 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. Management expects to meet its projections which include sufficient liquidity to fund operations to at least beyond June 30, 2011.

Under the terms of its credit facilities, the Company is required to satisfy certain restrictive covenants as to financial ratios. Certain of the financial ratios were not met for the period ended June 30, 2010. Consequently, on August 3, 2010, the Company executed an amending agreement to its Credit Agreement, providing for certain changes to the terms and conditions of its credit facility. Under the amending agreement, the credit facility has an authorized amount of $1,300,000 bearing interest at the Company’s bank’s prime rate plus 2.50% per annum and is repayable on demand. Furthermore, all the financial covenants have been removed by the bank under the amended agreement. In addition, the Company obtained a waiver relating to the breach of covenant under the previous agreement.

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 paragraphs, 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, increased spending together with an increase in backlogs, could accelerate the need for external financing and 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 expects to seek additional external funding, and there is no assurance that such efforts would be successful. Future changes in capital market 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 may be needed should the Company have insufficient liquidity. Such adjustments could be material.

2 Basis of presentation

These unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). However, these unaudited interim consolidated financial statements do not include all disclosures required under Canadian GAAP for annual consolidated financial statements and accordingly should be read in conjunction with the Company's latest annual consolidated financial statements and the notes thereto. In the opinion of management, these unaudited interim consolidated financial statements contain all the adjustments considered necessary.

3 Significant accounting policies

Basis of consolidation

These unaudited interim consolidated financial statements include the accounts of the Company and its subsidiaries, Xebec Adsorption (Shanghai) Co. Ltd. and Xebec Adsorption UK Limited, which was incorporated on April 22, 2010. They also include the Company's portion of the accounts of a joint venture, Xebec Adsorption South East Asia PTE. Ltd., accounted for using the proportionate consolidation method.

Intangible assets

Intangible assets comprise customer relations, patents, software and engineering drawings which are accounted for at cost and are amortized over their expected benefit to future periods.

Engineering drawings, which consist of engineering costs incurred to develop product plans, and software are amortized using the straight-line method over three years. Customer relations are amortized using the straight-line method over a period of seven years. Patent costs are amortized using the straight-line method over 15 years.

4 Recently issued accounting standard

In December 2009, the Emerging Issues Committee (“EIC”) of the Canadian Institute of Chartered Accountants issued Abstract EIC-175, “Multiple Deliverable Revenue Arrangements”, which requires a vendor to allocate arrangement consideration at the inception of an arrangement to all deliverables using the relative selling price method. EIC-175 also changes the level of evidence of the stand-alone selling price required to separate deliverables when more objective evidence of the selling price is not available. Given the requirement to use the relative selling price method of allocating arrangement consideration, EIC-175 prohibits the use of the residual method. EIC-175 may be applied prospectively and is applicable to revenue arrangements with multiple deliverables entered into or materially modified in the first annual fiscal period beginning on or after January 1, 2011, with early adoption permitted. The Company is evaluating the impact that this guidance may have on its consolidated financial statements.

5 Business combination

Pursuant to the arrangement between Xebec and QuestAir, the shareholders of Xebec (the “Vendors”) sold all of the issued and outstanding shares in the capital of Xebec to QuestAir in exchange for up to an aggregate of 15,241,976 common shares in the capital of QuestAir and 6,180,000 warrants of QuestAir. As a result of this transaction, the Vendors have received enough common shares of QuestAir to affect a reverse takeover of QuestAir. Accordingly, the financial statements of the Company reflect the accounts of QuestAir from June 12, 2009. The comparative financial statements included in these consolidated financial statements are those of Xebec. Subsequent to that transaction, QuestAir and Xebec have amalgamated and have continued as one corporation under the name of Xebec Adsorption Inc.

At the time of closing of the arrangement, the Vendors were issued 9,407,727 common shares, resulting in the Vendors initially controlling 45% of the outstanding common shares of the amalgamated company. The Vendors may increase their holdings in the amalgamated company by up to 5,834,249 common shares, resulting in an increase in the Vendors’ holdings from 45% to 57% pursuant to the earn-out provisions contained in the combination agreement if certain adjusted EBITDA performance targets are achieved by the amalgamated company following completion of the arrangement (in respect of the 2009 and 2010 fiscal years). These shares issued by QuestAir on completion of the arrangement are currently held in escrow.

The acquisition is accounted for using the purchase method of accounting. This method requires the determination of the aggregate purchase price, estimated at $13,043,898, for the net assets of QuestAir and allocation of this amount to assets acquired and liabilities assumed based on their estimated fair value.

During the second quarter, the Company finalized the purchase price allocation pertaining to this acquisition. The final allocation noted below, completed by management with the assistance of an independent valuator resulted in increases in accounts receivable of $466,699, in contract asset of $330,886, in customer relations of $1,900,000, in patents of $2,310,000, in accounts payable and accrued liabilities of $9,238 and decreases in inventories and deferred revenue of $1,724,201 and $1,229,682 respectively. As a result of these changes, the goodwill decreased by $4,503,828 and an adjustment of $303,066 was recorded to the cost of goods sold. The excess of the purchase price over the net identifiable assets acquired has been allocated to goodwill on the consolidated balance sheet.

	$
Assets acquired	
Cash and cash equivalents	5,122,028
Accounts receivable – net	1,922,000
Contract asset	330,886
Inventories	487,481
Prepaid expenses	173,354
Property, plant and equipment	939,223
Customer relations	1,900,000
Patents	2,310,000
Goodwill	1,438,324
Restricted cash	62,600
Total assets	14,685,896
Liabilities assumed	
Accounts payable and accrued liabilities	1,416,665
Deferred revenues	225,333
Total liabilities	1,641,998
Net assets acquired	13,043,898
Consideration	
11,269,318 Common shares	10,139,164
6,180,000 Warrants	1,782,259
199,347 Options	26,767
	11,948,190
Acquisition costs	1,095,708
	13,043,898

The consideration excludes a portion of the fair value of 70,183 unvested options.

The estimated fair value of the warrants was established using the Black-Scholes option pricing model with the following assumptions: exercise price of $2.15, risk-free interest rate of 1.40%, expected volatility of 100% and expected life of two years.

6 Intangible assets

	As at June 30, 2010		
	Cost $	**Accumulated depreciation $**	**Net amount $**
Software	406,590	158,950	247,640
Patents*	2,310,000	-	2,310,000
Customer relations*	1,900,000	-	1,900,000
Engineering drawings	4,700	2,350	2,350
	4,621,290	161,300	4,459,990

	As at December 31, 2009		
	Cost $	**Accumulated depreciation $**	**Net amount $**
Software	406,590	130,677	275,913
Engineering drawings	4,700	1,567	3,133
	411,290	132,244	279,046

* During the six-month period ended June 30, 2010, the Company allocated an amount of $4,210,000 (note 5) from goodwill to intangible assets as a result of the finalization of the purchase price allocation.

7 Bank loan

As at June 30, 2010, the Company had access to credit facilities in the amount of $1,500,000 which bore interest at the Company's bank's prime rate plus 0.60% per annum and were limited by certain margin requirements concerning accounts receivable. In addition, the Company had access to credit facilities in the amount of $500,000 which bore interest at the Company's bank's prime rate plus 1.50% per annum and were limited by certain requirements concerning pre-shipment costs. The bank loan was secured by a first ranking hypothec of $4,000,000 on all movable property of the Company and was renewable annually upon certain conditions. The Company was also required to comply with covenants requiring a minimum current ratio and maximum funded debt to tangible net worth. As at June 30, 2010, the Company was not in compliance with two covenants, namely the minimum current ratio and long-term debt to equity for which it has since obtained a waiver. As at June 30, 2010, the unused amount is approximately $963,000 for the first credit facility and $3,100 for the second facility. As well, the Company had access to a revolving demand facility by way of letters of credit and letters of guarantee amounting to $750,000. As at June 30, 2010, the unused portion of this demand facility is approximately $334,000 (2009 – $750,000). On August 3, 2010, the Company signed an amended agreement with the bank for the credit facilities (refer to note 1 for further information).

8 Research and development expenses

	For the three-month period ended June 30,		For the six-month period ended June 30,	
	2010 **$**	**2009** **$**	**2010** **$**	**2009** **$**
Research and development expenses	579,474	198,359	1,147,816	357,609
Government grants	(1,250)	(37,744)	(2,500)	(48,129)
Research and development tax credits	-	(34,888)	(24,200)	(110,006)
	578,224	125,727	1,121,116	199,474

9 Supplementary cash flow information

	For the three-month period ended June 30,		For the six-month period ended June 30,	
	2010 $	2009 $	2010 $	2009 $
Interest paid	75,244	53,852	143,452	128,379
Income taxes paid	-	-	-	27,351
Income taxes received	-	-	(27,351)	-

10 Segmented information

The Company specializes in the design and manufacture of filtration, purification, separation and dehydration equipment for gases. The Company has four product lines and provides related engineering services.

Revenue summarized by geographic area, as determined by the location of the customer, is as follows:

	For the three-month period ended June 30,		For the six-month period ended June 30,	
	2010 $	2009 $	2010 $	2009 $
North America	2,105,237	1,428,284	3,222,471	3,120,266
Europe	1,113,950	-	1,372,884	490,590
Asia	883,637	77,226	1,417,425	84,264
Middle East	27,670	1,595,475	109,364	4,113,244
South America	11,123	1,202,271	11,123	1,202,271
	4,141,617	4,303,256	6,133,267	9,010,635

Revenue summarized by product line is as follows:

	For the three-month period ended June 30,		For the six-month period ended June 30,	
	2010 **$**	**2009** **$**	**2010** **$**	**2009** **$**
Natural gas dryers	2,264,772	3,062,626	2,742,806	6,583,214
Aftermarket and field services	858,938	679,157	1,830,684	1,273,440
Air dryers	97,483	245,847	220,628	838,355
Gas purification	920,424	93,071	1,233,899	93,071
Engineering services	-	222,555	105,250	222,555
	4,141,617	4,303,256	6,133,267	9,010,635

Major customers representing 10% or more of total sales are as follows:

	For the three-month period ended June 30,		For the six-month period ended June 30,	
	2010 **$**	**2009** **$**	**2010** **$**	**2009** **$**
Customer A	1,110,639	1,202,271	1,110,639	1,202,271
Customer B	740,356	-	804,431	-
Customer C	-	1,311,624	-	3,102,904
	1,850,995	2,513,895	1,915,070	4,305,175

The location of the Company’s property, plant and equipment, intangible assets and goodwill by geographic region is as follows:

	As at June 30, 2010 **$**	**As at December 31, 2009** **$**
Canada	7,883,243	8,357,870
Asia	373,912	468,259
	8,257,155	8,826,129

11 Comparative figures

Certain comparative figures have been reclassified to conform to the current year's presentation.