QuestAir Technologies Inc.

First Quarter Report
Fiscal 2007

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

The following management discussion and analysis ("MD&A"), dated February 5, 2007, relates to our interim financial statements for the first quarter of fiscal 2007, being the three month period ended December 31, 2006. The MD&A should be read in conjunction with the Company's unaudited financial statements and related notes therein that are prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All financial information is stated in Canadian dollars, unless otherwise stated. Additional information regarding QuestAir Technologies Inc ("QuestAir" or "the Company"), including our Annual Information Form ("AIF") and MD&A for the financial year ended September 30, 2006 ("fiscal 2006"), can be found on the System for Electronic Document Analysis and Retrieval (SEDAR) at www.sedar.com.

Forward Looking Statements

This MD&A contains forward-looking statements, including statements regarding the future success of our business, technology, and market opportunities. Forward-looking statements typically contain words such as "believes", "expects", "anticipates", "continue", "could", "indicates", "plans", "will", "intends", "may", "projects", "schedule", "would" or similar expressions suggesting future outcomes or events, although not all forward-looking statements contain these identifying words. Examples of such statements include, but are not limited to, statements concerning: (i) management's belief that ethylene cracker offgas is an important source of waste hydrogen for recovery and reuse in the petrochemical industry, and that the H-6200 may be useful in larger capacity applications in this market in the future; (ii) management's belief that Latin America represents a significant potential growth market for the Company; (iii) management's belief that the anaerobic digester gas market represents a significant growth market in the United States; (iv) management's expectation that outflows of working capital in the quarter will be reversed in subsequent periods; (v) the European biogas market, which has been identified as a significant potential growth market for the Company; (vi) the expected shipment, installation and demonstration timeline of a commercial-scale prototype of the H-6200 hydrogen purifier and the resulting timing of receipt of stable operating data from this prototype; (vii) the expected continued growth in the sale of QuestAir's first generation gas purifiers in the industrial hydrogen and biogas markets; (viii) QuestAir's expected performance against the operational and financial milestones for fiscal 2007 including its revenue and cash burn targets; and (ix) QuestAir's intended efforts to mitigate the risk of reduction in demand for refined petroleum products. These statements are neither promises nor guarantees, but involve known and unknown risks and uncertainties that may cause our actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed in or implied by these forward-looking statements. These risks include risks related to revenue growth, operating results, industry and products, technology, competition and other factors described herein.

Although the forward-looking statements contained herein are based upon what management believes to be current and reasonable assumptions, the Company cannot assure readers that actual results will be consistent with these forward-looking statements. The forward-looking statements contained herein are made as of the date of this MD&A and are expressly qualified in their entirety by this cautionary statement. The Company undertakes no obligation to publicly update or revise any such statements to reflect any change in our expectations or in events, conditions, or circumstances on which any such statements may be based, or that may affect the likelihood that actual results will differ from those set forth in the forward-looking statements.

Business Overview

A detailed overview of QuestAir's business, including a summary of our core business, vision and strategy; key market drivers; key performance indicators; and resources and capabilities, is provided in our MD&A and AIF for the financial year ended September 30, 2006.

Significant Developments

QuestAir made the following progress in our commercial and development activities during the first quarter of fiscal 2007:

- In the industrial hydrogen market, we sold a H-3100 hydrogen purifier to recover hydrogen from ethylene cracker offgas at a polyethylene plant in Brazil which will be owned and operated by Polietilenos Uinão, a division of UNIPAR. This sale was notable since it was our first sale in Latin America, a significant potential growth market for the Company. More importantly, ethylene cracker offgas is an important source of waste hydrogen for recovery and reuse in the petrochemical industry, and we will be targeting larger capacity applications in this market with the H-6200 hydrogen purifier in the future.
- We further expanded the range of applications for our commercial products in the industrial hydrogen market, with sales of H-3200 purifiers into the steel and edible oil processing industries.
- During the quarter we also installed a M-3200 system to recover pipeline-grade methane from anaerobic digester gas at a dairy farm in Michigan. This project is the first application of QuestAir's pressure swing adsorption ("PSA") technology in the digester gas market, which is emerging as a significant growth market in the US - the US Environmental Protection Agency has identified over 6,900 farms across the US where digesters could cost effectively be operated.
- Early in the quarter, we renewed our Joint Development Agreement ("JDA") with ExxonMobil Research and Engineering ("EMRE"), extending the exclusivity period of the research collaboration in the refinery and petrochemical markets for a further three years. The objective of this extension is to allow additional product development work to be completed with EMRE to extend the H-6200 product platform into additional markets in the oil refining and petrochemical markets. Following the extension of the JDA, we completed two small funded research contracts with EMRE during the quarter to assess the use of the H-6200 platform in a specific petrochemical separation, as well as for the processing of "sour" natural gas. Options for the continuation of these research contracts are currently being assessed by the parties.

Financial Overview

The financial highlights for the first quarter of fiscal 2007 are noted below:

- Revenue was $1,643,476 for the quarter, increased by $771,703, or 89% compared to the same period in fiscal 2006.
- Sales order backlog at December 31, 2006 was $5,819,171, increased by $775,279, or 15%, from September 30, 2006.
- Cash used by operations and capital requirements was $4,104,553 for the quarter, increased by $1,782,283, or 77% compared to the same period in fiscal 2006.
- Net loss was $2,224,665 ($0.04 per share) for the quarter, increased by $156,795 or 8% compared to the same period in fiscal 2006.

Results of Operations

Revenues

The following table provides a breakdown of our revenues from the sale of gas purification systems and engineering service contracts for the reported periods:

(Unaudited, $ '000)	Three months ended December 31, 2006	2005
Gas purification systems	1,422	221
Engineering service contracts	221	651
Total revenue	1,643	872

The increase in revenue from gas purification systems for the first quarter of fiscal 2007 resulted from revenue recognized towards the construction of the prototype H-6200 hydrogen purifier to be demonstrated at an ExxonMobil refinery. For accounting purposes, the sale of the H-6200 prototype plant is treated as a long-term production-type contract. Consequently, in accordance with GAAP, revenue from the H-6200 prototype plant is recognized on a percentage-of-completion basis. No similar revenue was recognized in the same period in fiscal 2006.

The decrease in revenue from engineering service contracts for the first quarter of fiscal 2007 versus the same period in 2006 resulted from reduced levels of work completed on engineering service contracts with EMRE in the current year, as the focus of the refinery program shifted from product development to the construction of the prototype plant.

Fluctuations in recognized revenue and the receipt of new sales orders are to be expected in the industrial markets that we currently serve. In addition, the timing of receipt of new engineering service contracts can vary from year to year. Accordingly, we believe that recognized revenue and changes in our sales order backlog should be monitored together to determine the strength of our commercial operations.

QuestAir's sales order backlog is defined as future revenue from signed contracts that have not yet been recognized as revenue. The following table provides an analysis of the changes in our sales order backlog for the quarter ended December 31, 2006.

(Unaudited, $ '000)	For the quarter ended December 31, 2006		
	Gas Purification Systems	Engineering Service Contracts	Total
Opening Balance	4,908	136	5,044
Bookings	1,921	199	2,120
Revenue Recognized	(1,422)	(221)	(1,643)
Adjustments[1]	290	8	298
Ending Balance	5,697	122	5,819

The total sales order backlog increased by $775,279, or 15%, during the first quarter of fiscal 2007. The increase in backlog was driven by orders received during the quarter valued at $2,120,540, the majority of which related to new orders for our commercial products. This included an order valued at approximately $626,000 for an H-3100 hydrogen purifier to recover hydrogen from ethylene cracker offgas at a petrochemical plant in Brazil. Foreign exchange fluctuations during the quarter resulted in a positive adjustment to our sales order backlog of $298,215.

We currently expect that most of this sales order backlog as of December 31, 2006 will be recognized as revenue by September 30, 2007.

[1] Includes adjustments for fluctuations in foreign currency exchange rates.

Gross Profit

The following table provides a calculation of our gross profit for the reported periods:

(Unaudited, $ '000)	Three months ended December 31,	
	2006	2005
Sales	1,643	872
Cost of goods sold	1,355	118
Gross Profit	288	754
Gross Margin (%)	17.6%	86.5%

The decrease in gross margin for the first quarter of fiscal 2007 compared to the same period in fiscal 2006 resulted from a change in the mix of revenues recognized during the quarter. In the most recent quarter, a significant portion of the revenue recognized was from the prototype H-6200 hydrogen purifier that is being sold to an ExxonMobil refinery at cost. Additional information regarding this sale can be found in our MD&A for fiscal 2006. By comparison, the bulk of the revenues recognized in the first quarter of fiscal 2006 were from engineering service contracts, which typically contribute high gross margins.

Margins are expected to fluctuate each quarter depending on the mix of revenues recognized from engineering service contracts and gas purification systems.

Sales and Marketing

Sales and marketing expenses were $479,227 for the quarter ended December 31, 2006, an increase of 26% compared to $380,135 for the same period in fiscal 2006. The increase in sales and marketing expenses for the quarter was attributed to an increased level of sales activities compared to the prior period.

Research and Development

The gross Research and Development ("R&D") expenditures, offsetting government funding and the resulting net R&D expenditures for the relevant periods, were as follows:

(Unaudited, $ '000)	Three months ended December 31,	
	2006	2005
Gross R&D Expenditure	1,625	1,746
Less: Government & Partner Funding	385	473
Net R&D Expenditure	1,240	1,273

The 7% reduction in gross R&D expenditures for the first quarter of fiscal 2007 compared to the same period in fiscal 2006 was due to a reduction in the amount of R&D undertaken, as resources were redirected towards supporting our commercial sales efforts and the construction of the prototype H-6200 hydrogen purifier. Government funding decreased for the quarter in proportion to the reduction in R&D undertaken on the refinery development program with EMRE, which is eligible for funding from Technology Partnerships Canada.

General and Administrative

General and Administrative ("G&A") expenses were $839,110 for the first quarter of fiscal 2007, an increase of 5% from $798,386 for the same period in fiscal 2006. The increase in G&A expenses for the quarter related to increases in salary and consulting expenses, partially offset by reductions in regulatory, accounting and legal expenses compared to the prior period.

Amortization

Amortization expenses were $230,362 for the quarter ended December 31, 2006 compared to $374,632 for the same period in fiscal 2006. The decrease in amortization expenses was a result of certain capital assets becoming fully amortized during the prior fiscal year.

Other Income

Other income was $276,021 for the first quarter of fiscal 2007 compared to $3,890 in the same period in fiscal 2006. The increase in other income resulted from an increase in foreign exchange gains and increased interest income earned from funds raised in an equity offering in May 2006 (see 'Liquidity and Capital Resources').

Net Loss

Net loss for the quarter ended December 31, 2006 was $2,224,665 ($0.04 per share) compared to $2,067,870 ($0.06 per share) for the same period in fiscal 2006. The increase in the net loss for the quarter was primarily a result of reduced gross profits compared to the prior period, partially offset by lower R&D and amortization expenses and higher interest income.

Loss per share is calculated based on the weighted average number of common shares outstanding through the quarter. The reduction in the loss per share for the quarter ended December 31, 2006 was a result of an increase in the weighted average number of common shares outstanding compared to the prior period (refer to 'Outstanding Share Data').

Capital Expenditures

Capital expenditures net of Government funding and proceeds on sale ("Net CAPEX"), for the first quarter of fiscal 2007 was $261,319 compared to $330,933 for the same period in fiscal 2006. Net CAPEX for the quarter includes the completion of leasehold improvements made to new hydrogen testing facilities that were built during fiscal 2006 which were included in accounts payable at the end of the fiscal year, and subsequently paid during the current quarter.

It is expected that capital expenditures will fluctuate from quarter to quarter depending on the requirements of specific product development programs and administrative needs.

Summary of Quarterly Results

(Unaudited, $'000 except loss per share data)	2006				2005			
	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31
Total Revenues	1,643	2,697	1,193	2,796	872	1,159	2,644	1,491
Gas Purification Systems	1,423	2,530	574	2,483	221	373	2,307	480
Eng. Service Contracts	220	167	619	313	651	786	337	1,011
% Gross Margin	18%	3%	40%	(7%)	87%	45%	27%	78%
R&D (net)	1,240	1,330	1,236	1,253	1,273	1,436	1,491	1,533
General & Administrative	839	835	776	902	798	917	941	773
Net Loss	2,225	2,724	2,135	3,336	2,068	2,588	2,562	1,843
Net Loss per share	(0.04)	(0.05)	(0.05)	(0.09)	(0.06)	(0.06)	(0.07)	(0.05)
Net CAPEX	261	615	354	70	331	19	575	292
Cash used in Operations & Net CAPEX	4,105	3,508	1,876	1,724	2,322	2,295	1,673	2,732
Backlog	5,819	5,044	4,976	5,840	5,702	3,008	3,471	5,356
Gas Purification Systems	5,697	4,908	4,570	4,815	4,359	2,240	1,848	3,623
Eng. Service Contracts	122	136	406	1,025	1,343	768	1,623	1,733

Our operating results have fluctuated from quarter to quarter and this trend is expected to continue for the foreseeable future.

Revenues are comprised of sales of gas purification systems and engineering services contracts. The mix of these revenues and amount of revenue has fluctuated quarter by quarter based on the length of the sales cycle required to close customer orders, and on contractual terms related to the timing of delivery and acceptance of products and services by customers. As a result, percentage gross margins have fluctuated significantly from quarter to quarter. In general, gross margins on engineering service contracts are higher than those on gas purification systems, resulting in increased gross margins for quarters with a high proportion of recognized revenue from engineering service contracts.

R&D expenses have generally decreased over the past four quarters as a result of a shift in the focus of the refinery program with EMRE from product development to the construction of the prototype plant and commercialization.

G&A expenses have also varied quarter by quarter, largely as a result of quarterly variations in stock-based compensation expenses, legal, regulatory and investor relations costs.

Cash Flows, Liquidity and Capital Resources

Cash Flows

Cash and cash equivalents were $9,760,735 at December 31, 2006, a decrease of $1,258,065 from $11,018,800 at September 30, 2006. This decrease in cash and cash equivalents during the quarter was driven by cash outflows from net operating losses and changes in working capital of $3,843,234, partially offset by cash inflows from investing activities and financing activities of $2,403,661 and $181,508 respectively.

Cash used by operations for the first quarter of fiscal 2007 was $3,843,234, compared to $1,991,337 for the same period in fiscal 2006. The increase in cash used by operations for the quarter was driven by an increased loss for the period, as well as significant changes in non-cash working capital. Accounts payable and accrued liabilities decreased $1,887,233 in the quarter, reflecting the payment of various supplier invoices related to the construction of the H-6200 prototype plant that had been received late in the prior quarter. Due to the nature of the contracts related to the construction and sale of this plant, certain suppliers have been paid prior to receipt of offsetting funds from the ExxonMobil refinery. Timing delays in the receipt of grants receivables contributed to the reduction in non-cash working capital during the quarter. These increases in uses of cash during the quarter were partially offset by increases in deferred revenue and a reduction in prepaid expenses. The outflows of working capital in the quarter are expected to be reversed in subsequent periods as cash is received from our customers and granting agencies.

Net cash flow from investing activities for the quarter ended December 31, 2006 was $2,403,661, compared to $330,933 for the same period in fiscal 2006. The increase in cash inflows from investing activities for the quarter primarily related to the maturity of $2,400,000 in short-term investments converted to cash and cash equivalents. No similar investments matured in the prior year. The increase in cash inflows from investing activities was also attributed to a decrease in restricted cash set aside to fund remaining equipment purchases for the H-6200 prototype plant in fiscal 2007.

Net cash flow from financing activities was $181,508 for the first quarter of fiscal 2007 compared to $3,646 for the same period in fiscal 2006. The cash inflow in the quarter resulted primarily from a net increase in bank debt in the period as we drew down on our equipment line with Comerica Bank (see 'Credit Facilities'). No similar draw was made in the prior period.

We monitor cash used by operations and capital requirements as a measure of our operational cash burn. Cash used by operations and capital requirements for the first quarter of fiscal 2007 was $4,104,553, compared to $2,322,270 for the same period in fiscal 2006. It should be noted that this metric is a non-GAAP measure of operational cash burn. The calculation of this measure of cash usage and a reconciliation of this financial measure to the statement of cash flows is as follows:

(Unaudited, $ '000)	Three months ended December 31, 2006	2005
Cash used in Operating Activities	(3,843)	(1,991)
Add: purchase of property, plant and equipment ("PP&E")	(267)	(364)
Add: government grants and funding related to PP&E	5	33
Cash used in Operations and Capital Requirements	(4,105)	(2,322)
Reconciliation to GAAP Statements of Cash Flow:		
Add: Short-term investments	2,400	-
Add: restricted cash	265	-
Add: Cash from Financing Activities	182	3
Increase in Cash and Cash Equivalents	(1,258)	(2,319)

The increase in cash burn for the first quarter of fiscal 2007 compared to the same period in fiscal 2006 is primarily due to the reduction in non-cash working capital discussed above. It is expected that cash burn will decrease considerably in future quarters as the outflow of working capital is reversed.

Liquidity and Capital Resources

Since incorporation, we have financed our operations through cash generated from commercial sales, the issuance of equity and funding received from government and strategic partners. At December 31, 2006 cash and short-term investments were $14,760,735, compared to $18,418,800 at September 30, 2006. Not included in cash and short-term investments at December 31, 2006 was $991,374 of restricted cash, which will primarily be used to fund remaining equipment purchases for the H-6200 prototype plant in fiscal 2007.

We expect to use our current cash resources to complete the development and commercialization of our products currently under development, as well as new products that we may choose to develop in the future. Our capital requirements may vary depending on a number of factors, including contributions from the sale of our systems and engineering service contracts, the progress of our current development programs and any decisions to enter into additional programs or partnerships. In addition, we review investment and acquisition opportunities for technologies and products that would complement our business or assist us in our commercialization plans. An investment opportunity would increase our capital requirements. If current funding and cash generated from operations is insufficient to satisfy our operating requirements, we may seek to sell additional equity or to arrange debt or other financing.

Credit Facilities

During fiscal 2005, we signed a credit facilities agreement with Comerica Bank. This agreement was amended and restated as part of the renewal of these facilities in June 2006. The amended credit facilities include a US$1 million accounts receivable line of credit and a US$2 million term loan, in addition to $673,212 outstanding under the original term loan agreement. Both facilities are subject to annual renewal. As at December 31, 2006, we had drawn $1,065,758 against the term loans net of repayments. We are in compliance with all of our bank covenants.

Contractual Obligations

The following table lists our contractual obligations at December 31, 2006. We expect to fund these expenditures out of our cash reserves:

(Unaudited, $ '000)	Payments due by Period				
	Total	In the next year	2-3 years	4-5 years	After 5 years
Bank debt	1,066	479	587	-	-
Capital leases	-	-	-	-	-
Operating leases	1,133	512	499	122	-
Purchase obligations[2]	2,774	2,774	-	-	-
Total contractual obligations	4,973	3,765	1,086	122	-

Contingent Off-Balance Sheet Financing Arrangements

We have received funding contributions from various programs of the Canadian Government to support the development and commercialization of our gas purification technology. A summary of these funding arrangements is provided in our MD&A for fiscal 2006. We did not enter into any new contingent off-balance sheet financing arrangements during the quarter.

Outstanding Share Data

Common Shares Outstanding

On May 31, 2006 we completed an offering of common shares, issuing 14,815,000 common shares from treasury. As a result, our authorized share capital consists of an unlimited number of common shares, of which 52,393,065 common shares were issued and outstanding as of December 31, 2006, unchanged from September 30, 2006. We also have an unlimited number of preferred shares authorized, none of which are issued.

The following table provides the weighted average number of common shares outstanding for the relevant periods:

(Unaudited)	Three months ended December 31,	
	2006	2005
Weighted Average Common Shares Outstanding	52,393,065	37,337,298

The average number of common shares outstanding increased for the quarter ended December 31, 2006 compared to the same period in fiscal 2006 as a result the issuance of 14,815,000 new common shares upon the closing of our equity offering on May 31, 2006.

Stock Options and Warrants Outstanding

As at December 31, 2006 there were 4,904,401 stock options and 192,308 share purchase warrants outstanding which collectively could result in the issuance of 5,096,709 common shares if such options and warrants are exercised by the holders in accordance with the terms thereof.

Subsequent Events

Following the end of the quarter, we announced that we have successfully achieved one of our key corporate milestones for fiscal 2007 with the receipt of an order for a M-3200 system to recover pipeline-grade methane from anaerobic digester gas in Switzerland. This is our first sale into the European biogas market, which has been identified as a significant potential growth market for the Company.

In addition, we built on the strong sales momentum established in the first quarter, securing an order from Air Liquide U.S. for a H-3100 to recover waste hydrogen in the petrochemical industry.

[2] Purchase obligation is defined as an agreement to purchase goods or services that is enforceable or legally binding on the Company that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.

We also extended our M-3100 product line into the processing of well-head natural gas, securing an order from a large independent oil producer for a M-3100 to remove carbon dioxide and other contaminants from natural gas to meet the demanding quality specifications of Californian gas utilities.

Collectively, these orders demonstrate the growing market traction of our commercial PSA products, as well as the broad applicability of QuestAir's product platforms in a range of industrial and energy-related markets.

Outlook

Our priorities for the next few months include shipping the prototype H-6200 hydrogen purifier to ExxonMobil's European refinery. Construction resources at our key supplier in Texas remain tight, and based on our supplier's current schedule, we expect to ship the prototype plant by mid-April.

An April shipment of the prototype will place some pressure on our marketing timeline for the H-6200, given that stable operating data from the prototype unit may only be available in mid 2007. However, we continue to aggressively market the H-6200 together with EMRE, with the objective of securing our first commercial sale this fiscal year.

We also aim to build on the excellent momentum that we have developed with the sales of our commercial gas purification products. Specific areas for near-term growth include the biogas upgrading market, both in Europe and North America, as well as hydrogen recovery and on-site hydrogen generation.

Based on our current level of backlog and contracts under negotiation, we remain comfortable with our revenue guidance of $9-10 million and our cash burn guidance of $7-8 million for the fiscal year.

Critical Accounting Policies and Estimates

The significant accounting policies that we believe to be most critical in fully understanding and evaluating our financial results are revenue recognition, stock-based compensation, inventory valuation and warranty provisions. These accounting principles require us to make certain estimates and assumptions. We believe that the estimates and assumptions upon which we rely are reasonable based upon information available at the time that these estimates and assumptions are made. Actual results may differ from our estimates. Our critical accounting estimates affect our net loss calculation and the balance sheet value of our assets and liabilities. Our accounting policies are described in note 2 to the audited consolidated financial statements for the financial year ended September 30, 2006.

Revenue Recognition

We earn revenues from the sale of commercial gas purification systems, long-term production-type contracts, and from engineering service contracts. Revenue recognized from long-term production-type contracts and engineering service contracts are determined under the percentage-of-completion method, whereby revenues are recognized on a pro rata basis in relation to contact costs incurred. There is a risk that estimated costs to complete a contract might change, which may result in an adjustment to revenues previously recorded.

During the quarters ended December 31, 2006 and 2005 there were no material adjustments to long-term production-type contract and engineering service contract revenue relating to revenue recognized in a prior period.

Stock-based compensation
We account for stock options using the fair value method calculated using the Black-Scholes option pricing model. This requires that certain inputs into the model, including the expected life of the options and expected volatility of the stock, be estimated at the time the options are awarded. We amortize the fair value over the vesting period of the options, generally a period of four years. Should these estimates prove to be incorrect, the actual fair value of the options may differ from the estimated fair value of the options, resulting in a different stock compensation expense calculation.

Inventory
In establishing whether or not a provision is required for inventory obsolescence, we estimate the likelihood that inventory carrying values will be affected by changes in market demand for our products and by changes in technology, which could make inventory on hand obsolete. We perform regular reviews to assess the impact of changes in technology, sales trends and other changes on the carrying value of inventory. Where we determine that such changes have occurred and that they will have a negative impact on the carrying value of inventory on hand, adequate provisions are made.

The majority of our inventory is purchased directly to work in process when a customer order is received, and only a small portion is held in raw materials. This reduces the exposure to provisions for obsolescence. For the quarter ended December 31, 2006, raw materials on hand of $566,357 includes $55,645 of spare parts inventory available for sale to customers for use on commercial units in the field.

Warranty Provision
A provision for warranty costs is recorded on commercial gas purification systems at the time of commissioning and customer acceptance. In estimating the accrued warranty liability, past and projected experience and the nature of the contracts are considered. Should these estimates prove to be incorrect, we may incur costs different from those provided for in our warranty provision. In each of the quarters ended December 31, 2006 and 2005, actual warranty costs incurred were less than the provision recorded.

Changes in Accounting Policies Including Initial Adoption

The CICA released new standards related to financial instruments in April 2005: Section 3855, *Financial Instruments – Recognition and Measurement*; Section 3865, *Hedges*; Section 1530, *Comprehensive Income*; Section 3861, *Financial Instruments – Disclosure and Presentation*; and Section 3251, *Equity*. These sections specify when a financial instrument or non-financial derivative is to be recognized on the balance sheet. These sections require a financial instrument or non-financial derivative to be measured at fair value or using cost-based measures; establish how gains and losses are recognized and presented, including introducing comprehensive income; specify how hedge accounting is applied; and establish new disclosures about an entity's accounting for designated hedging relationships and the methods and assumptions applied in determining fair values.

Under these new standards, derivatives typically arise when the currency of our sales orders is different from both the functional currencies of QuestAir and our international customers, and such derivatives are recognized as either assets or liabilities on the balance sheet at fair value. All gains and losses (realized or unrealized) from such derivatives are recognized in the income statement in the period in which they occur.

We use the following methods and assumptions to estimate the fair value of our financial instruments:

(i) *Cash and cash equivalents:* The carrying amount reported on the balance sheet approximates fair value.
(ii) *Accounts receivable:* The carrying amount reported on the balance sheet approximates fair value.
(iii) *Debt securities:* Short-term investments are classified as held to maturity and their carrying value approximates fair value being amortized cost using the effective interest method.
(iv) *Debt:* The carrying amount of the floating rate debt approximates fair value.

The mandatory effective date for Sections 1530, *Comprehensive Income*; 3855, *Financial Instruments – Recognition and Measurement*; 3865, *Hedges*; 3861, *Financial Instruments – Disclosure and Presentation*; 3251, *Equity* affect interim and annual financial statements for fiscal years beginning on or after October 1, 2006. Earlier adoption was permitted only as of the beginning of a fiscal year ending on or after December 31, 2004. QuestAir has elected to adopt all of these new standards effective October 1, 2006 on a prospective basis. Management is of the opinion that if any restatement of comparative financial statements was required, its effect would be minor.

Internal Controls and Procedures

There were no changes in our internal control over financial reporting that occurred during the most recent quarter that may have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

Risks & Uncertainties

A detailed explanation of the risk factors which we face is provided in our AIF for the year ended September 30, 2006 at www.sedar.com. A number of the key risks, as well as the strategies that management employs to manage these risks, are discussed briefly below:

Technology and Competitive Risks

The H-6200 hydrogen purifier incorporating QuestAir's second generation PSA technology is in the development stage. Risks remain related to the successful completion of the product development program, and our ability to meet the required cost, reliability and performance standards of a viable commercial offering. We have undertaken a rigorous review of the key technical risk areas in collaboration with ExxonMobil in order to manage these risks. Nevertheless, technical risks and uncertainties will remain until the prototype plant has been successfully demonstrated at the ExxonMobil refinery site.

We currently face, and will continue to face competition from suppliers of conventional PSA systems as well as alternate gas purification technologies. We will continue to invest in fundamental R&D to continually improve the performance and cost position of our products. In addition, we pursue an active patenting program to protect our proprietary technology and competitive position.

Market Risks

The market opportunity for our H-6200 hydrogen purifier is driven in part by the growth in demand for refined petroleum products. A significant reduction in the demand for these fuels, as a result of such events as an economic recession in key markets in the US and China for example, could significantly impact our growth prospects. In order to mitigate this risk, we intend to diversify our market exposure by extending the H-6200 product platform into markets outside of oil refining, such as petrochemical separations, natural gas processing and the production of high purity hydrogen for industrial uses.

In addition, the rate at which our H-6200 hydrogen purifier is adopted in the refinery market is also subject to risk and uncertainty, and could have a material impact on the future profitability of the Company. We seek to mitigate this risk by diversifying the application of the H-6200 product platform into a number of large existing markets. Our fuel cell related products provide additional diversification outside of the traditional energy industry.

In the longer term, there is significant uncertainty regarding the commercial viability of fuel cell technology and the adoption of fuel cell powered automobiles and power products. We seek to manage this risk by focusing on the sale of our existing commercial products in the nascent fuel cell market, and pacing our fuel cell related development programs to the level of engagement of and funding received from our fuel cell partners.

Regulatory Risk

Demand for our refinery related products is also driven in part by regulations mandating the reduction of sulphur levels in transportation fuels such as gasoline and diesel. In addition the expected demand for fuel cell technologies in the transportation sector is driven in part by local air pollution regulations and regulatory pressures to reduce greenhouse gas emissions. It is clear that a significant roll-back in any of these regulations could materially impact our growth prospects. Our strategy of diversifying our market opportunities into multiple markets is intended to minimize our exposure to regulatory risk in specific markets.

Partner Risk

A key component of our strategy is to partner with market leaders in the development, marketing and distribution of new products. We have developed close relationships with EMRE for its refinery and petrochemical related products, and also with Shell Hydrogen for the emerging hydrogen fueling market. Our current business and/or future prospects would be materially impacted if EMRE or Shell Hydrogen were to terminate their relationships with QuestAir. We have structured our key development agreements with these parties such that we are free to sell to third parties, and we seek to establish relationships with multiple customers in each of the markets that we target in order to mitigate this risk.

Financial Risk

We are currently a net consumer of cash, and we may have to raise additional capital in order to complete our long term product development and commercialization plans. It is possible that our future growth prospects could be significantly impacted if we are unable to raise additional capital on acceptable terms. In order to mitigate this risk, we have implemented a disciplined cash management strategy to limit cash consumption. In addition we are actively pursuing other forms of financial support such as government and partner funding in order to reduce our net cash requirements.

Key Personnel Risk

Our future growth depends in large part on our ability to recruit, train and retain key management and technical personnel. Competition for qualified personnel in our industry is intense, and it is possible that we may not be able to recruit suitable personnel into key positions in the future. We have implemented an innovative retention strategy in order to manage this risk, which includes active career development, and a recognition and compensation program that rewards both group and individual contributions and performance.

Balance Sheets

Unaudited (expressed in Canadian dollars)	As at December 31 2006	As at September 30 2006
ASSETS		
Current assets:		
Cash and cash equivalents (note 4)	$9,760,735	$ 11,018,800
Restricted cash (note 5)	991,374	1,256,354
Short-term investments (note 6)	5,000,000	7,400,000
Accounts receivable	1,740,616	1,476,024
Grants and funding receivables	844,597	454,597
Inventories	4,064,379	3,510,508
Prepaid expenses	211,884	337,335
Derivatives (note 7)	36,680	-
	22,650,265	25,453,618
Property, plant and equipment	1,884,203	2,103,626
Other long-term assets	132,600	125,000
	$24,667,068	$27,682,244
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$2,276,039	$4,413,717
Deferred revenue	3,017,382	1,946,781
Current portion of bank debt (note 8)	478,604	351,398
	5,772,025	6,711,896
Long term liabilities:		
Bank debt (note 8)	587,154	532,852
	6,359,179	7,244,748
Shareholders' equity:		
Share capital		
Authorized		
Unlimited common shares, voting, no par value		
Unlimited preferred shares, issuable in series, no par value		
Common shares (note 9a)	109,020,202	109,020,202
Contributed surplus (note 9b)	6,582,677	6,462,772
Deficit	(97,294,990)	(95,045,478)
	18,307,889	20,437,496
	$24,667,068	$27,682,244

Statements of Operations, Comprehensive Loss and Deficit

Unaudited (expressed in Canadian dollars)	For the three months ended December 31 2006	December 31 2005
Revenues	$1,643,476	$871,773
Cost of goods sold	1,355,036	117,801
Gross Profit	288,440	753,972
Operating expenses		
Research and development – net (note 11)	1,240,427	1,272,579
General and administration	839,110	798,386
Sales and marketing	479,227	380,135
Amortization	230,362	374,632
	2,789,126	2,825,732
Loss before undernoted	(2,500,686)	(2,071,760)
Other income (expense)		
Interest income	156,073	50,641
Other	119,948	(46,751)
	276,021	3,890
Loss for the period	(2,224,665)	(2,067,870)
Other comprehensive income	-	-
Comprehensive loss for the period (note 9d)	(2,224,665)	(2,067,870)
Deficit – Beginning of period	(95,045,478)	(84,782,560)
Unrealized foreign exchange loss on derivatives (note 9c)	(24,847)	-
Deficit – End of period	$(97,294,990)	$(86,850,430)
Basic and diluted loss per share	$(0.04)	$(0.06)
Weighted average number of common shares outstanding	52,393,065	37,337,298

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Statements of Cash Flows

Unaudited (expressed in Canadian dollars)	For the three months ended December 31 2006	December 31 2005
Cash flows from operating activities		
Loss for the period	$(2,224,665)	$(2,067,870)
Items not involving cash		
Amortization	230,362	374,632
Gain on sale of property, plant and equipment	(65)	-
Unrealized foreign exchange gain on derivatives (note 7)	(61,527)	-
Non-cash compensation expense	119,905	121,571
	(1,935,990)	(1,571,667)
Changes in non-cash operating working capital		
Accounts, grants and funding receivables	(654,592)	(672,567)
Inventories	(553,870)	(561,260)
Prepaid expenses	117,851	73,641
Accounts payable and accrued liabilities (note 14)	(1,887,233)	(325,378)
Deferred revenue	1,070,600	1,065,894
	(1,907,244)	(419,670)
	(3,843,234)	(1,991,337)
Cash flows from investing activities		
Decrease in short-term investments	2,400,000	-
Purchase of property, plant and equipment (note 14)	(266,819)	(363,775)
Government grants and funding related to property, plant and equipment	5,435	32,842
Proceeds on sale or property, plant and equipment	65	-
Decrease in restricted cash	264,980	-
	2,403,661	(330,933)
Cash flows from financing activities		
Issuance of common shares on exercise of stock options	-	21,716
Issuance of bank debt	248,505	-
Repayment of bank debt	(66,997)	(18,070)
	181,508	3,646
Decrease in cash and equivalents	(1,258,065)	(2,318,624)
Cash and equivalents – Beginning of period	11,018,800	10,414,219
Cash and equivalents – End of period	$9,760,735	$8,095,595

Notes to the financial statements

Unaudited (all dollar amounts expressed in Canadian dollars)

1. Description of business

QuestAir Technologies Inc. (the "Company"), a federally incorporated Canadian company, is an emerging developer, manufacturer and supplier of advanced pressure swing adsorption ("PSA") gas purification systems. PSA systems are used extensively in the production of hydrogen, oxygen and nitrogen for a wide variety of industries. The Company's products, which incorporate patented, proprietary technology, primarily target hydrogen purification in a range of existing industrial and energy markets, including oil refinery and gas processing applications, as well as emerging markets, such as fuel cell systems for distributed power generation and retail service stations which will provide hydrogen fuel for fuel cell powered vehicles.

While the accompanying interim financial statements have been prepared on a going concern basis, which contemplates the realization of assets and liquidation of liabilities during the normal course of operations, certain adverse conditions and events cast doubt upon the validity of this assumption. The Company has not yet realized profitable operations and has relied on non-operational sources of financing to fund operations, and, as at December 31, 2006, has an accumulated deficit of $97,294,990. The Company's ability to continue as a going concern will be dependent on management's ability to successfully execute its business plan. The Company may seek additional forms of financing, but cannot provide assurance that it will be successful in doing so. These interim financial statements do not include adjustments or disclosures that may result from the Company's inability to continue as a going concern. If the going concern assumption is not appropriate for these interim financial statements, then adjustments would be necessary in the carrying value of assets and liabilities, and the reported net losses, and balance sheet classification used.

2. Unaudited interim financial statements

The unaudited balance sheet at December 31, 2006 and the unaudited interim statements of operations, comprehensive loss and deficit and cash flows for the three months ended December 31, 2006 and 2005, have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), on the same basis as the audited financial statements of the Company for the year ended September 30, 2006. These interim financial statements include all adjustments, which, in the opinion of management, are necessary for the fair presentation of the results of operations for the interim periods presented. Results for the three months ended December 31, 2006 are not necessarily indicative of the results to be expected for the full year. These unaudited interim financial statements do not include all the disclosures required for annual financial statements, and should be read in conjunction with the Company's annual audited financial statements for the year ended September 30, 2006, and the summary of significant accounting policies included therein.

3. Significant Accounting Policies

These unaudited interim financial statements follow the same accounting policies and methods of their application as the Company's annual audited financial statements for the year ended September 30, 2006 with the exception of accounting for financial instruments.

The Company has adopted CICA Handbook Sections 3855, *Financial Instruments – Recognition and Measurement*; Section 3865, *Hedges*; Section 1530, *Comprehensive Income*; Section 3861, *Financial Instruments – Disclosure and Presentation;* and Section 3251, *Equity*, effective October 1, 2006 on a prospective basis. Among other things, these sections specify when a financial instrument or non-financial derivative is to be recognized on the balance sheet; require a financial instrument or non-financial derivative to be measured at fair value or using cost-based measures, and establish how gains and losses are to be recognized and presented, including the introduction of comprehensive income.

The following methods and assumptions are used to estimate the fair value of the Company's financial instruments:

a) Cash and cash equivalents: The carrying amount reported on the balance sheet approximates fair value.
b) Accounts receivable: The carrying amount reported on the balance sheet approximates fair value.
c) Debt securities: Short-term investments are classified as held to maturity and their carrying value approximates fair value being amortized cost using the effective interest method.
d) Debt: The carrying amount of the floating rate debt approximates fair value.

4. Cash and cash equivalents

Cash is comprised of unrestricted bank deposits some of which are interest bearing. Cash equivalents consist of money market accounts and bankers acceptances that are readily convertible to known amounts of cash and are held to their original maturities within ninety days from their date of purchase. They are carried at cost, plus accrued interest, which approximates fair value.

5. Restricted cash

During 2006, the Company was required to deposit cash with Comerica Bank as collateral to secure its obligations under irrevocable standby and documentary letters of credit. Restricted cash is released as the letters of credit are drawn upon or expire. Expiry dates of the letters of credit vary and extend to March 31, 2007. In addition, TD Bank requires a restricted deposit to secure corporate credit card debt. Restricted cash at December 31, 2006 of $991,374 (September 30, 2006 - $1,256,354) relates to letters of credit of $930,927 (September 30, 2006 - $1,196,889) and corporate credit card security of $60,447 (September 30, 2006 - $59,465).

6. Investments

The Company's investments consist of banker's acceptances, and are classified as held to maturity for accounting purposes and are carried on the balance sheets at amortized cost using the effective interest method plus accrued interest. The Company does not exercise significant influence with respect to these investments. Investments with maturities of greater than ninety days and less than one year are classified as short-term investments.

7. Derivatives

The Company has adopted CICA Handbook Sections 3855, *Financial Instruments – Recognition and Measurement*. Accordingly, derivative instruments typically arise when the currency of the Company's sales orders is different from both the functional currencies of the Company and its international customers. All derivative instruments are recognized as either assets or liabilities on the balance sheet at fair value. The accounting for changes in gains and losses of a derivative instrument depends on whether it meets the qualifications for, and has been designated as a hedge, and the type of hedge. All gains and losses (realized or unrealized) from derivative instruments not designated as hedges have been recognized in the statement of operations in the period in which they occur.

Included in the loss for the three months ended December 31, 2006 is a $61,527 unrealized foreign exchange gain on such embedded derivatives.

8. Bank debt

In April 2005, the Company signed a credit facilities agreement with Comerica Bank. This agreement was amended and restated as part of the renewal of these facilities in June 2006. The amended credit facilities include: a US$1 million accounts receivable line of credit; a term loan of $673,212 ("Tranche 1") equal to the balance outstanding at June 2006 under the original term loan agreement; and new term loan of US$2 million ("Tranche 2"). These facilities are subject to annual renewal, and are secured by the assets of the Company with certain exceptions. Under the terms of the agreement, the Company must comply with financial covenants and certain other business terms.

As at December 31, 2006, the Company had drawn $1,065,758 (September 30, 2006 - $803,964) on the term loans. Accrued interest payable as at December 31, 2006 was $3,124 (September 30, 2006 - $3,399). Total interest expense was $9,661 (December 31, 2005 - $9,017) for the quarter ended December 31, 2006. Draws can be made against the Tranche 2 term loan, to a maximum of US$2 million, prior to June 21, 2007.

9. Shareholders' Equity

Changes to shareholders' equity for the three months ended December 31, 2006 are presented below:

Unaudited (expressed in Canadian dollars)				For the three months ended December 31, 2006		
	Common Shares	Contributed Surplus	Accumulated Other Comprehensive Income (Loss)	Deficit	Total Shareholders' Equity	Comprehensive Loss
Balance at September 30, 2006	$109,020,202	$6,462,772	-	$(95,045,478)	$20,437,496	-
Net Loss				(2,224,665)	(2,224,665)	$(2,224,665)
Adjustment to opening balance of unrealized foreign exchange loss on derivatives	-	-	-	(24,847)	(24,847)	
Total comprehensive loss						$(2,224,665)
Stock-based compensation on fair value ESOP	-	119,905	-	-	119,905	
December 31,2006	$109,020,202	$6,582,677	-	$(97,294,990)	$18,307,889	

a) Common shares – issued and outstanding

Authorized share capital consists of an unlimited number of common shares of which 52,393,065 common shares were issued and outstanding as of December 31, 2006. No common shares were issued during the three months ended December 31, 2006. An unlimited number of preferred shares are authorized, none of which are issued.

b) Contributed surplus

During the three months ended December 31, 2006 $119,905 (December 31, 2005 - $121,571) stock-based compensation on share options issued to employees under the fair value method was recorded in contributed surplus.

c) Deficit

Effective October 1, 2006, the Company has adopted new valuation principles required for financial instruments. In accordance with CICA Handbook Section 3855 *Financial Instruments – Recognition and Measurement*, the difference between the previous carrying amount and fair value of derivatives other than those that are designated and effective hedging items are recognized as an adjustment of the balance of retained earning at the beginning of the fiscal year in which this Section is initially applied. An adjustment to retained earnings of $24,847 was made to reflect the difference between the carrying amount (being zero) and the fair value of embedded derivatives in sales contracts at September 30, 2006. (See also note 7)

d) Comprehensive loss

Comprehensive income (loss) is the increase or decrease in equity from sources other than owners and is comprised of net income and other revenues, expenses, gains, and losses that, pursuant to Canadian GAAP, are excluded from net income (loss). The Company had no other comprehensive income or loss during the quarter, therefore the comprehensive loss equals net loss of $2,224,665 for the quarter ended December 31, 2006.

10. Share options

Prior to 2004 the Company granted stock options to certain employees in lieu of cash bonuses and salary. As cash compensation was foregone by these employees, options of equivalent value were issued to them at an exercise price of $0.001 per share. At December 31, 2006, the Company has 280,979 (September 30, 2006 – 282,929) options in lieu of salary or bonus outstanding.

The Company first adopted an incentive stock option plan (the "Plan") in 1998 to provide its employees, officers, directors and consultants with options to purchase common shares of the Company. Immediately prior to the initial public offering on December 21, 2004, certain terms of the Plan were amended, and the Company's stock option pool was increased from 3,785,241 to 5,507,637 stock options (excluding any options that were issued as compensation for performance in lieu of salary or bonus). Under the terms of the Plan, stock options are granted with an exercise price not less than the fair market value of the Company's common shares on the date of grant. Stock options generally vest quarterly over four years. In no event can a stock option be exercisable for more than 10 years from the date of grant. At December 31, 2006, 468,629 (September 30, 2006 - 437,921) options are available for issuance under the Company's Plan.

The Company calculates the fair value of each share option grant on the date of grant using the Black-Scholes option valuation model. No options were issued under the Plan during the quarter ended December 31, 2006.

Share option activity for the three months ended December 31, 2006 is presented below:

Unaudited Three months ended December 31, 2006	Number of Options	Weighted average exercise price	Expiry Dates
Outstanding – September 30, 2006 (3,413,604 share options exercisable)	4,937,059	$1.34	
Granted	-	-	
Exercised	-	-	
Forfeited	32,658	$1.74	
Outstanding – December 31, 2006 (3,571,007 share options exercisable)	4,904,401	$1.34	Feb. 14, 2007 to Sep. 26, 2016

11. Research and development

Unaudited	Three months ended December 31 2006	December 31 2005
Research and development costs	$1,624,992	$1,745,228
Government grants and funding from third parties under development agreements	(384,565)	(472,649)
	$1,240,427	$1,272,579

12. Commitments and contingencies

1. Technology Partnerships Canada ("TPC") Program

   Fast Cycle Pressure Swing Adsorption and Gas Management systems

   On June 6, 2003, the Company entered into an agreement with the Canadian Federal Minister of Industry under the TPC Program to receive financial contributions regarding the development and commercial exploitation of its Rapid Cycle Pressure Swing Adsorption and Gas Management systems.

   Pursuant to the agreement, total project costs for the period from October 1, 2002 to September 30, 2007 will be shared, subject to annual contribution limits, such that the Minister's contribution will not exceed the lesser of 30% of eligible project costs and $9,600,000.

   The Company has claimed contributions aggregating $8,150,083 up to December 31, 2006 (September 30, 2006 - $7,760,083). Of this amount, $6,934,887 (September 30, 2006 - $6,550,322) has been allocated against research and development expenses, $715,196 (September 30, 2006 - $709,761) has been allocated against the cost of property, plant and equipment, and $500,000 (September 30, 2005 - $500,000) is reflected as share purchase warrants. For the three months ended December 31, 2006, $384,565 (December 31, 2005 - $472,649) has been allocated against research and development expenses, and $5,435 (December 31, 2005 - $32,841) has been allocated against the cost of property, plant and equipment.

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

i) the issuance of 192,308 transferable warrants convertible into common shares at a strike price of $3.88, exercisable for a term of five years, and

ii) repayable contributions to the Minister during the royalty period based on 1.165% of gross business revenues.

The royalty period began on October 1, 2005 and will end on September 30, 2013 if the cumulative royalties reach a ceiling of $23,620,000. If the cumulative royalties are less than $23,620,000 at September 30, 2013, the royalty period will continue until the earlier of September 30, 2021 or until a cumulative royalty ceiling of $23,620,000 is reached. Any amounts ultimately determined to be repayable are accrued as a liability when determinable. As of December 31, 2006, $173,035 (September 30, 2006 - $146,800) has been accrued as a liability. Under the agreement, royalties are due on January 31 of each year, beginning in 2007.

13. Segmented information

The Company's overall focus is on the development and commercialization of gas purification systems, being the Company's only segment.

Summarized product sales and service revenue by geographic area, as determined by the location of the customer, is as follows:

Unaudited	Three months ended	
	December 31	December 31
Region	2006	2005
Europe	$1,016,278	-
United States	380,730	$659,849
Asia	246,468	82,124
Canada	-	129,800

All of the Company's property, plant and equipment are located in Canada.

Major customers, representing 10% or more of period sales, include:

Unaudited	Three months ended	
	December 31	December 31
	2006	2005
Customer A	$1,268,557	$ 610,979
Customer B	-	129,800

14. Supplemental cash flow information

Unaudited	Three months ended December 31 2006	December 31 2005
Supplemental cash flow information:		
Cash paid for interest	11,043	8,690
Cash received for interest	128,436	49,442
Cash paid for taxes	-	-
Non-cash operating, investing and financing activities:		
Property, plant and equipment included in accrued liabilities	(250,444)	-