QuestAir Technologies Inc.

Second 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 May 9, 2007, relates to our interim financial statements for the three and six month periods ended March 31, 2007. 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 indicated. 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) the expected shipment, installation and demonstration timeline of the prototype H-6200 hydrogen purifier and the resulting timing of receipt of operating data from this prototype; (ii) management's estimates of expected future costs to complete the manufacturing, shipment, installation and commissioning of the prototype H-6200 hydrogen purifier and of future warranty expenses that may be incurred related to this prototype; (iii) management's estimate of severance costs and termination benefits that will be payable to employees affected by the reorganization of the Company's operations; (iv) management's expectation that the reorganization will result in a reduction of year-on-year operating expenses and that it will lower costs in fiscal 2008; (v) management's belief that the Company has sufficient financial resources to fund operations for at least the next 18 months; (vi) the expected continued growth in the sale of QuestAir's first generation gas purifiers in the industrial hydrogen and biogas markets; (vii) the expected timing of receipt of one or more engineering services contracts and the associated impact on financial performance; (viii) the expected timing of the first commercial sale of an H-6200 hydrogen purifier; (ix) QuestAir's expected performance against the operational and financial milestones for fiscal 2007 including its revenue and cash burn targets; and (x) 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 activities during the second quarter of fiscal 2007:

- Orders were received for two M-3200 pressure swing adsorption ("PSA") systems to recover pipeline grade methane from biogas at two anaerobic digester projects in Switzerland. The receipt of these orders met the Company's milestone to secure a purchase order for a methane purification system in the European biogas market.
- An order for a M-3100 PSA system to upgrade contaminated natural gas at an existing gas processing plant in California. This was our first sale into the gas processing market.
- A $0.7 million order was received from Air Liquide U.S. for a H-3100 PSA system to recover waste hydrogen from a petrochemical plant in Texas. This was our second sale into the petrochemical industry, which represents another promising market for QuestAir's commercial products.

Financial Overview

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

- Revenue was $872,746 for the quarter, decreased by $1,923,598, or 69% compared to the same period in fiscal 2006. Revenue for the half year was $2,516,222, decreased $1,151,895, or 31%, from $3,668,117 for the same period last year.
- Sales order backlog at March 31, 2007 was $7,512,827, increased by $1,693,656, or 29%, from December 31, 2006.
- Cash used by operations and capital requirements was $1,209,697 for the quarter, decreased by $514,104, or 30% compared to the same period in fiscal 2006. Cash used by operations and capital requirements for the half year was $5,314,250, compared to $4,046,071 for the same period in fiscal 2006. At March 31, 2007, we had $14.5 million in cash and short term investments, including restricted cash of $1.4 million.
- Net loss was $4,316,857 ($0.08 per share) for the quarter, increased by $981,203 or 29% compared to the same period in fiscal 2006. Net loss for the half year increased to $6,541,522 ($0.12 per share) from $5,403,524 ($0.14 per share) for the same period in 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)	Three months ended March 31,		Six months ended March 31,	
	2007	2006	2007	2006
Gas purification systems	857,708	2,482,677	2,280,553	2,704,041
Engineering service contracts	15,039	313,667	235,669	964,076
Total revenue	872,746	2,796,344	2,516,222	3,668,117

The decrease in revenue from gas purification systems for the quarter and half year ended March 31, 2007 resulted from less revenue being recognized related to the construction of the prototype H-6200 hydrogen purifier ("prototype plant") compared to the prior period. The prototype plant is being sold to an ExxonMobil refinery in Europe. For accounting purposes, the sale of the prototype plant is treated as a long-term production-type contract and, in accordance with GAAP, revenue is recognized on a percentage-of-completion basis. In addition, revenue during the quarter and half year ended March 31, 2007 was lower than anticipated as certain gas purification systems remain in our sales order backlog pending commissioning at customer sites. We expect that these units will be successfully commissioned during the balance of the fiscal year, allowing us to recognize revenue on these projects later in the year.

The decrease in revenue from engineering service contracts for the quarter and half year ended March 31, 2007 compared to the same period in 2006 resulted from the fact that engineering services contracts represent a smaller portion of the Company's sales order backlog. Work has therefore focused on delivering orders of commercial equipment and completing 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 and half year ended March 31, 2007.

(Unaudited)	For the three months ended March 31, 2007			For the six months ended March 31, 2007		
	Gas Purification Systems	Engineering Service Contracts	Total	Gas Purification Systems	Engineering Service Contracts	Total
Opening Balance	5,696,921	122,250	5,819,171	4,908,298	135,594	5,043,892
Bookings	2,174,825	338,875	2,513,700	4,095,965	538,275	4,634,240
Revenue Recognized	(857,708)	(15,039)	(872,746)	(2,280,553)	(235,669)	(2,516,222)
Adjustments[1]	64,298	(11,596)	52,702	354,626	(3,709)	350,917
Ending Balance	7,078,336	434,491	7,512,827	7,078,336	434,491	7,512,827

The total sales order backlog increased by $1,693,656, or 29%, during the second quarter of fiscal 2007. The increase in backlog was driven by orders received during the quarter valued at $2,513,700, the majority of which related to new orders for our commercial products. During the quarter, QuestAir sold a number of methane and hydrogen purification systems which contributed $2,174,825 to the growth in backlog. Also during the quarter we received a small follow-on engineering services contract related to the development of a system for hydrogen purification on-board a vehicle. Foreign exchange fluctuations during the quarter resulted in a positive adjustment to our sales order backlog of $52,702.

Gross Profit

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

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

(Unaudited)	Three months ended March 31, 2007	2006	Six months ended March 31, 2007	2006
Sales	872,746	2,796,344	2,516,222	3,668,117
Cost of goods sold	2,235,122	2,992,057	3,590,158	3,109,858
Gross Profit	(1,362,376)	(195,713)	(1,073,936)	558,259
Gross Margin (%)	(156%)	(7.0%)	(42.7%)	15.2%

The decrease in gross profit for the quarter and half year ended March 31, 2007 compared to the same periods in fiscal 2006 resulted from the recognition of an estimated loss of $1,750,749 on the prototype plant being sold to an ExxonMobil refinery. $950,783 of this amount has already been incurred for salary and travel expenses related to expediting suppliers and site visits. The balance of the loss, $799,966, represents an updated estimate of future costs related to the prototype plant, of which $376,721 is management's estimated loss to be incurred to complete the manufacturing, shipment, installation and commissioning of the prototype plant, and $423,245 is a warranty provision. The sales contract for the prototype plant includes a mechanical warranty, and therefore we must estimate a warranty expense when recognizing revenue. For the sale of commercial equipment, this would be estimated at the time of commissioning and customer acceptance; however, as any warranty expense for the prototype plant would increase the expected loss on this project, management has estimated a warranty provision based on prior experience with test equipment and newly developed gas purification systems and included such provision in the expected loss on this sale in accordance with GAAP. (See also 'Use of Estimates' and 'Warranty Provision' under 'Critical Accounting Policies and Estimates'.) Additional information regarding this sale can be found in our MD&A for fiscal 2006.

Sales and Marketing

Sales and marketing expenses were $548,825 for the quarter ended March 31, 2007, decreased by 9% compared to $605,068 for the same period in fiscal 2006. Although sales activities increased in the quarter compared to the prior period, overall sales and marketing expenses declined in the quarter due to lower commission and market research expenditures. For the half year ended March 31, 2007, sales and marketing expenses were $1,028,052, increased by 4% compared to $985,203 for the same period in 2006. This increase is 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)	Three months ended March 31 2007	2006	Six months ended March 31, 2007	2006
Gross R&D Expenditure	1,530,934	1,747,274	3,155,926	3,492,502
Less: Government & Partner Funding	(327,660)	(493,629)	(712,226)	(966,278)
Net R&D Expenditure	1,203,273	1,253,645	2,443,700	2,526,224

The 4% and 3% reduction in net R&D expenditures for the quarter and half year ended March 31, 2007 compared to the same periods 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 plant. Government funding decreased for the quarter in proportion to the reduction in R&D undertaken on the refinery development program with ExxonMobil Research and Engineering ("EMRE"), which is eligible for funding from Technology Partnerships Canada.

General and Administrative

General and Administrative ("G&A") expenses were $987,300 for the second quarter of fiscal 2007, increased by 9% from $901,794 for the same period in fiscal 2006. For the half year ended March 31, 2007, G&A expenses were $1,826,410, increased by 7% from $1,700,180 for the same period in 2006. The increase in the quarter and half year ended March 31, 2007 resulted from increases in salary, consulting, directors' fees and regulatory expenses, partially offset by reductions in accounting and legal expenses compared to the prior periods.

Amortization

Amortization expenses were $201,450 for the quarter ended March 31, 2007 compared to $389,226 for the same period in fiscal 2006. For the half year ended March 31, 2007 amortization was $431,812 compared to $763,858 for the same period in fiscal 2006. The decrease in amortization expenses was a result of certain capital assets becoming fully amortized during the current and prior fiscal years.

Other Income

Other income and expenses netted to an expense of $13,633 for the quarter ended March 31, 2007 compared to income of $9,792 for the same period in fiscal 2006. For the half year ended March 31, 2007 other income was $262,388 compared to $13,682 for the same period in fiscal 2006. The increase in other expenses for the quarter was related to an increase in interest income, offset by increased losses from foreign exchange and unrealized derivatives. The increase in other income for the half year 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 March 31, 2007 was $4,316,857 ($0.08 per share) compared to $3,335,654 ($0.09 per share) for the same period in fiscal 2006. Net loss for the half year ended March 31, 2007 was $6,541,522 ($0.12 per share) compared to $5,403,524 ($0.14 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 (see 'Gross Profit').

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 and half year ended March 31, 2007 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 second quarter of fiscal 2007 was $88,735 compared to $66,584 for the same period in fiscal 2006. Net CAPEX for the half year ended March 31, 2007 was $350,054, compared to $397,517 for the same period in 2006. 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)	2007 Mar 31	2006 Dec 31	Sep 30	Jun 30	Mar 31	2005 Dec 31	Sep 30	Jun 30
Total Revenues	873	1,643	2,697	1,193	2,796	872	1,159	2,644
Gas Purification Systems	858	1,423	2,530	574	2,483	221	373	2,307
Eng. Service Contracts	15	220	167	619	313	651	786	337
% Gross Margin	(156%)	18%	3%	40%	(7%)	87%	45%	27%
R&D (net)	1,203	1,240	1,330	1,236	1,253	1,273	1,436	1,491
General & Administrative	987	839	835	776	902	798	917	941
Net Loss	4,317	2,225	2,724	2,135	3,336	2,068	2,588	2,562
Net Loss per share	(0.08)	(0.04)	(0.05)	(0.05)	(0.09)	(0.06)	(0.06)	(0.07)
Net CAPEX	89	261	615	354	70	331	19	575

(Unaudited, $'000 except loss per share data)	2007 Mar 31	2006 Dec 31	Sep 30	Jun 30	Mar 31	2005 Dec 31	Sep 30	Jun 30
Cash used in Operations & Net CAPEX	1,210	4,105	3,508	1,876	1,724	2,322	2,295	1,673
Backlog	7,513	5,819	5,044	4,976	5,840	5,702	3,008	3,471
Gas Purification Systems	7,078	5,697	4,908	4,570	4,815	4,359	2,240	1,848
Eng. Service Contracts	435	122	136	406	1,025	1,343	768	1,623

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 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 of the H-6200 hydrogen purifier.

G&A expenses have varied quarter to 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 $8,124,503 at March 31, 2007, a decrease of $1,636,232 from $9,760,735 at December 31, 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 $1,120,962, cash outflows from investing activities of $461,309 and cash outflows from financing activities of $53,961. Cash and cash equivalents decreased $2,894,297 for the half year ended March 31, 2007, driven by cash outflows from net operating losses and changes in working capital of $4,964,196 partially offset by cash inflows from investing and financing activities of $1,942,352 and $127,547 respectively.

Cash used by operations for the second quarter of fiscal 2007 was $1,120,962, compared to $1,657,217 for the same period in fiscal 2006. The decrease in cash used by operations for the quarter was driven by significant changes in non-cash working capital, partially offset by the increased loss for the period. Accounts payable and accrued liabilities increased $1,202,534 in the quarter, reflecting the accrued costs to complete construction of and the warranty provision for the prototype plant. Deferred revenue increased as several progress payments were received for orders in progress. For the half year ended March 31, 2007, cash used by operations was $4,964,196, compared to $3,648,554 for the same period in 2006. Higher losses were partially offset by increases in deferred revenue compared to the prior period.

Net cash outflow from investing activities for the second quarter of fiscal 2007 was $461,309, compared to $1,179,315 for the same period in fiscal 2006. The decrease in cash outflows from investing activities for the quarter compared to the same period in 2006 primarily related to a lower amount of cash being restricted during the current quarter. Restricted cash increased in the second quarter of fiscal 2006 in order to fund equipment purchases for the prototype plant; by comparison, restricted cash increased to a lesser extent in the second quarter of fiscal 2007 due to provisions in certain commercial contracts with customers to secure customer deposits with letters of credit. For the half year ended March 31, 2007, net cash inflow from financing activities was $1,942,352, compared to a cash outflow of $1,510,248 in the same period in fiscal 2006. The increase in cash inflows from investing activities for the half year related primarily 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.

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 second quarter of fiscal 2007 was $1,209,697, compared to $1,723,801 for the same period in fiscal 2006. Cash used by operations and capital requirements for the half year ended March 31, 2007 was $5,314,250, compared to $4,046,071 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)	Three months ended March 31, 2007	Three months ended March 31, 2006	Six months ended March 31, 2007	Six months ended March 31, 2006
Cash used in Operating Activities	(1,120,962)	(1,657,217)	(4,964,196)	(3,648,554)
Add: purchase of property, plant and equipment ("PP&E")	(99,448)	(93,894)	(366,267)	(457,669)
Add: government grants and funding related to PP&E	10,428	23,810	15,863	56,652
Add: proceeds from sale of PP&E	285	3,500	350	3,500
Cash used in Operations and Capital Requirements	(1,209,697)	(1,723,801)	(5,314,250)	(4,046,071)
Reconciliation to GAAP Statements of Cash Flow:				
Add: Short-term investments	-	-	2,400,000	-
Add: restricted cash	(372,574)	(1,112,731)	(107,594)	(1,112,731)
Add: Cash from Financing Activities	(53,961)	3,496	127,547	7,142
Increase in Cash and Cash Equivalents	(1,636,232)	(2,833,036)	(2,894,297)	(5,151,660)

The increase in cash burn for the half year ended March 31, 2007 compared to the same period in fiscal 2006 is primarily due to the increased loss in the current period as well as the changes in non-cash working capital discussed above.

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 March 31, 2007 cash and short-term investments were $13,124,503, compared to $14,760,735 at December 31, 2006. Not included in cash and short-term investments at March 31, 2007 was $1,363,948 of restricted cash, which will be used in part to fund certain supplier payments for the prototype plant in fiscal 2007. Additional funds currently restricted to secure customer deposits will become unrestricted upon QuestAir completing the construction of certain customer orders.

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. At forecasted cash burn rates, we believe that we have sufficient financial resources to fund our operations for at least the next 18 months.

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 March 31, 2007, we had drawn $953,008 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 March 31, 2007. 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	953	454	499	-	-
Capital leases	-	-	-	-	-
Operating leases	999	507	393	99	-
Purchase obligations[2]	2,546	2,546	-	-	-
Total contractual obligations	4,498	3,507	892	99	-

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 52,503,920 common shares were issued and outstanding as of March 31, 2007, increased by 110,855 or 0.2% from December 31, 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 March 31,		Six months ended March 31,	
	2007	2006	2007	2006
Weighted Average Common Shares Outstanding	52,442,386	37,438,314	52,417,454	37,387,251

The average number of common shares outstanding increased for the half year ended March 31, 2007 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.

[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.

Stock Options and Warrants Outstanding
As at March 31, 2007 there were 4,904,165 stock options and 192,308 share purchase warrants outstanding which collectively could result in the issuance of 5,096,473 common shares if such options and warrants are exercised by the holders in accordance with the terms thereof.

Subsequent Events

In order to focus more resources on commercial activities, we have undertaken a reorganization of our operations, effective immediately.

This reorganization directs the majority of our resources on expanding the sales of our commercial PSA products, and on the critical engineering and order-to-delivery functions required to support our marketing efforts in the global oil refining market. As part of this new focus, we will be adding to our sales and marketing and order-to-delivery functions in order to ensure continued growth in our commercial products.

We are reducing our overall research and development expenses, although we have retained a core R&D capability and we will continue to develop new gas purification products in areas where we see a unique value proposition for our technology and committed financial support from lead customers and partners.

This reorganization will result in a reduction in year-on-year operating expenses of approximately $1.5 million, and includes the elimination of 12 full time positions, representing 14% of QuestAir's current workforce. These changes will result in a restructuring charge of approximately $650,000 being recognized in the third quarter of fiscal 2007.

Outlook

We are focused on three key priorities for the remainder of the fiscal year: the successful start up and operation of the prototype plant at ExxonMobil's refinery in Europe; continued growth in the sales of our commercial gas purification products; and successfully securing an engineering service contract to bring our rapid cycle PSA technology into a new market.

During a final quality review of the prototype plant at our supplier in Houston, QuestAir personnel found that a component of the plant was assembled incorrectly. This component is part of the feed gas pre-treatment section of the plant, and is unrelated to the rapid cycle PSA modules. Corrective action is underway, and is expected to be completed within the next few weeks. As soon as the component has been re-installed, we will ship the completed skid to the European refinery.

We expect the installation and start up of the prototype plant to be completed at the European refinery before the end of our fiscal year. Although we continue to actively market the H-6200 together with ExxonMobil, we believe that it will be challenging for us to achieve our objective of a first commercial H-6200 sale during fiscal 2007.

We also aim to build on the momentum that we have developed with the sales of our commercial gas purification products in the first half of fiscal 2007. 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.

Our efforts to secure a significant engineering services contract to lever our rapid cycle PSA technology and extend the H-6200 platform into a new market such as natural gas processing or petrochemicals separation are continuing. Over the past few months, we have secured and completed small scoping studies regarding opportunities in these potential markets. Discussions with potential partners are continuing, however it is taking longer to secure a follow on contract than we originally anticipated.

When we issued guidance on revenue and cash burn for fiscal 2007 on December 5, 2006, we indicated that we had made certain assumptions regarding the receipt of new engineering services contracts and gas purification sales in determining such guidance, and that failure to secure certain contracts may have a material impact on our recognized revenue and cash burn for the year. The delay in receipt of new engineering service contracts will result in lower revenue being recognized and less cash being received in fiscal 2007 than was previously expected.

Moreover, while we have seen considerable traction in our sales of commercial equipment, many of the contracts received in the second quarter will not be recognized as revenue until fiscal 2008. This highlights one of the challenges in forecasting revenues for a fiscal year: it is often difficult to predict the timing of revenue recognition, particularly on larger systems sales, as the timing of commissioning and start up is determined primarily by the customer's timeline and not by QuestAir's delivery schedule.

In addition, the incremental costs to complete the prototype plant and the restructuring charge that will be incurred in the third quarter will increase the total cash burn in the fiscal year. While the reorganization of the Company's operations to focus on commercial activities is expected to result in annualized cash savings of approximately $1.5 million, restructuring expenses will offset such savings over the balance of fiscal 2007. As such, the reorganization is expected to result in lower overall costs in fiscal 2008.

Based on the current sales order backlog, the updated estimate of timing of cash receipts as well as the factors noted above, we now expect recognized revenue for fiscal 2007 to be between $7.0 and $8.0 million, and cash burn for the fiscal year to be between $10.0 and $12.0 million. These compare to the guidance set out in December 2006 of recognized revenue of $9.0 to $10.0 million and cash burn of between $7.0 and $8.0 million.

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 provision. 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.

Use of Estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from these estimates.

During the second quarter of fiscal 2007, we recognized an incremental loss on the prototype plant of $1,750,749, which includes expected costs for the equipment incorporated therein (which is estimated using exchange rates in effect at March 31, 2007), and expected future costs for labour and travel expenses as well as warranty costs. Estimated warranty expenses are discussed below (see 'Warranty Provision'). Costs for labour and travel expenses have been estimated based on costs incurred in the first half of fiscal 2007 and adjusted to reflect residual work expected to be required to complete the start up of the prototype plant at the refinery site.

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 March 31, 2007 and 2006 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 March 31, 2007, raw materials on hand of $634,657 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.

During the quarter ended March 31, 2007, a warranty provision of $423,245 was recorded and included in the estimated loss on the prototype plant. This represents management's estimate of the possible future costs to repair and/or service the prototype plant, based on prior experience with test equipment and newly developed systems (rather than standard commercial equipment).

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 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, rapid cycle 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.

QuestAir Technologies Inc.
Unaudited Interim Financial Statements
March 31, 2007 and 2006
(expressed in Canadian dollars)

Balance Sheets

	As at March 31, 2007	As at September 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents (note 4)	$8,124,503	$11,018,800
Restricted cash (note 5)	1,363,948	1,256,354
Short-term investments (note 6)	5,000,000	7,400,000
Accounts receivable	1,349,599	1,476,024
Grants and funding receivables	725,165	454,597
Inventories	3,883,203	3,510,508
Prepaid expenses	387,366	337,335
	20,833,784	25,453,618
Property, plant and equipment	1,717,960	2,103,626
Other long-term assets	171,860	125,000
	$22,723,604	$27,682,244
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$3,424,760	$4,413,717
Deferred revenue	4,135,786	1,946,781
Current portion of bank debt (note 8)	453,754	351,398
Derivatives (note 7)	34,687	-
	8,048,987	6,711,896
Long term liabilities:		
Bank debt (note 8)	499,254	532,852
	8,548,241	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)	109,293,375	109,020,202
Contributed surplus (note 9b)	6,493,835	6,462,772
Deficit	(101,611,847)	(95,045,478)
	14,175,363	20,437,496
	$22,723,604	$27,682,244
Commitments and contingencies (note 12)		

(expressed in Canadian dollars)

Statements of Operations, Comprehensive Loss and Deficit

	For the three months ended		For the six months ended	
	March 31, 2007	March 31, 2006	March 31, 2007	March 31, 2006
Revenues	$872,746	$2,796,344	$2,516,222	$3,668,117
Cost of goods sold	2,235,122	2,992,057	3,590,158	3,109,858
Gross Profit	(1,362,376)	(195,713)	(1,073,936)	558,259
Operating expenses				
Research and development – net (note 11)	1,203,273	1,253,645	2,443,700	2,526,224
General and administration	987,300	901,794	1,826,410	1,700,180
Sales and marketing	548,825	605,068	1,028,052	985,203
Amortization	201,450	389,226	431,812	763,858
	2,940,848	3,149,733	5,729,974	5,975,465
Loss before undernoted	(4,303,224)	(3,345,446)	(6,803,910)	(5,417,206)
Other income (expense)				
Interest income	140,059	38,822	296,132	89,463
Other	(153,692)	(29,030)	(33,744)	(75,781)
	(13,633)	9,792	262,388	13,682
Loss for the period	(4,316,857)	(3,335,654)	(6,541,522)	(5,403,524)
Other comprehensive income	-	-	-	-
Comprehensive loss for the period (note 9d)	(4,316,857)	(3,335,654)	(6,541,522)	(5,403,524)
Deficit – Beginning of period	(97,294,990)	(86,850,430)	(95,070,325)	(84,782,560)
Unrealized foreign exchange loss on derivatives (note 9c)	-	-	-	-
Deficit – End of period	$(101,611,847)	$(90,186,084)	$(101,611,847)	$(90,186,084)
Basic and diluted loss per share	$(0.08)	$(0.09)	$(0.12)	$(0.14)
Weighted average number of common shares outstanding	52,442,386	37,438,314	52,417,454	37,387,251

(expressed in Canadian dollars)

Statements of Cash Flows

	For the three months ended March 31, 2007	For the three months ended March 31, 2006	For the six months ended March 31, 2007	For the six months ended March 31, 2006
Cash flows from operating activities				
Loss for the period	$(4,316,857)	$(3,335,654)	$(6,541,522)	$(5,403,524)
Items not involving cash				
Amortization	201,450	389,226	431,812	763,858
Gain on sale of property, plant and equipment	(285)	(8,074)	(350)	(8,074)
Unrealized foreign exchange loss on derivatives (note 7)	71,367	-	9,840	-
Non-cash compensation expense	125,543	124,919	245,448	246,490
Foreign currency loss	-	503	-	503
	(3,918,782)	(2,829,080)	(5,854,772)	(4,400,747)
Changes in non-cash operating working capital				
Accounts, grants and funding receivables	510,449	159,821	(144,143)	(512,746)
Inventories	181,175	948,055	(372,695)	386,795
Prepaid expenses	(214,742)	(110,340)	(96,891)	(36,699)
Accounts payable and accrued liabilities (note 14)	1,202,534	836,332	(684,699)	510,954
Deferred revenue	1,118,404	(662,005)	2,189,004	403,889
	2,797,820	1,171,863	890,576	752,193
	(1,120,962)	(1,657,217)	(4,964,196)	(3,648,554)
Cash flows from investing activities				
Decrease in short-term investments	-	-	2,400,000	-
Purchase of property, plant and equipment (note 14)	(99,448)	(93,894)	(366,267)	(457,669)
Government grants and funding related to property, plant and equipment	10,428	23,810	15,863	56,652
Proceeds on sale or property, plant and equipment	285	3,500	350	3,500
Increase in restricted cash	(372,574)	(1,112,731)	(107,594)	(1,112,731)
	(461,309)	(1,179,315)	1,942,352	(1,510,248)
Cash flows from financing activities				
Issuance of common shares on exercise of stock options	58,788	57,706	58,788	79,422
Issuance of bank debt	-	-	248,505	-
Repayment of bank debt	(112,749)	(54,210)	(179,746)	(72,280)
	(53,961)	3,496	127,547	7,142
Decrease in cash and equivalents	(1,636,232)	(2,833,036)	(2,894,297)	(5,151,660)
Cash and equivalents – Beginning of period	9,760,735	8,095,595	11,018,800	10,414,219
Cash and equivalents – End of period	$8,124,503	$5,262,559	$8,124,503	$5,262,559
Supplemental cash flow information (note 14)				

Notes to the financial statements

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 March 31, 2007, has an accumulated deficit of $101,611,847. 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 March 31, 2007 and the unaudited interim statements of operations, comprehensive loss and deficit and cash flows for the six months ended March 31, 2007 and 2006, 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 and six months ended March 31, 2007 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 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 three months 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 October 31, 2007. In addition, TD Bank requires a restricted deposit to secure corporate credit card debt. Restricted cash at March 31, 2007 of $1,363,948 (September 30, 2006 - $1,256,354) relates to letters of credit of $1,303,501 (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.

(expressed in Canadian dollars)

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 six months ended March 31, 2007 is a $9,840 unrealized foreign exchange loss 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 March 31, 2007, the Company had drawn $953,008 (September 30, 2006 - $884,250) on the term loans. Accrued interest payable as at March 31, 2007 was $2,736 (September 30, 2006 - $3,399). Total interest expense was $17,055 (March 31, 2006 - $8,944) for the quarter ended March 31, 2007. 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 and six months ended March 31, 2007 are presented below:

	For the three months ended March 31, 2007					
	Common Shares	Contributed Surplus	Accumulated Other Comprehensive Income (Loss)	Deficit	Total Shareholders' Equity	Comprehensive Loss
December 31, 2006	$109,020,202	$6,582,677	-	$(97,294,990)	$18,307,889	-
Net Loss				(4,316,857)	(4,316,857)	(4,316,857)
Total comprehensive loss						$(4,316,857)
Exercise of share options	58,788	-	-	-	58,788	
Stock-based compensation allocated to common shares on exercise of share options	214,385	(214,385)	-	-	-	
Stock-based compensation on fair value share options	-	125,543	-	-	125,543	
March 31, 2007	$109,293,375	$6,493,835	-	$(101,611,847)	$14,175,363	

(expressed in Canadian dollars)

For the six months ended March 31, 2007						
	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				(6,541,522)	(6,541,522)	(6,541,522)
Adjustment to opening balance of unrealized foreign exchange loss on derivatives	-	-	-	(24,847)	(24,847)	
Total comprehensive loss						$(6,541,522)
Exercise of share options	58,788	-	-	-	58,788	
Stock-based compensation allocated to common shares on exercise of share options	214,385	(214,385)	-	-	-	
Stock-based compensation on fair value share options	-	245,448	-	-	245,448	
March 31, 2007	$109,293,375	$6,493,835	-	$(101,611,847)	$14,175,363	

a) Common shares – issued and outstanding

Authorized share capital consists of an unlimited number of common shares of which 52,503,920 common shares were issued and outstanding as of March 31, 2007. During the three months ended March 31, 2007, 110,855 common shares were issued on exercise of share options. An unlimited number of preferred shares are authorized, none of which are issued.

b) Contributed surplus

During the three months ended March 31, 2007 $125,543 (March 31, 2006 - $124,919) 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 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 $4,316,857 for the quarter ended March 31, 2007 and $6,541,522 for the six months ended March 31, 2007.

(expressed in Canadian dollars)

10. Share options

The Company has issued stock options under two different stock-based incentive plans. The 2004 Stock Option Plan ("2004 Plan") only allowed for the issuance of stock options. On February 6, 2007, Shareholders approved the adoption of the 2006 Omnibus Plan (the "2006 Plan"), which allows for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards and other stock-based awards. Upon adoption of the 2006 Plan, Common shares approved for issuance under all stock-based compensation arrangements increased from 5,507,637 to 5,915,603.

All option agreements entered into under the 2004 Plan will continue to be governed by the terms of the 2004 Plan; however, the Corporation will not grant any new options under the 2004 Plan and will grant future options solely under the 2006 Plan. Under the terms of the 2006 Plan, stock options are granted with an exercise price not less than the volume weighted average trading price of the Common shares for the five trading days prior to the date of grant. Stock options generally vest quarterly over four years and are exercisable for seven years (ten years under the 2004 Plan) from the date of grant. At March 31, 2007, 900,583 (September 30, 2006 - 437,921) Common shares are available for issuance pursuant to awards made under the 2006 Plan. No other form of stock-based awards have been issued under the 2006 Plan as at March 31, 2007. Full details of the 2006 Plan can be found in the Company's Management Information Circular dated January 5, 2007.

The Company calculated the minimum fair value of each share option grant on the date of grant using the Black-Scholes option valuation model with the following weighted average assumptions:

		Six months ended
	March 31 2007	March 31 2006
Dividend yield	0%	0%
Expected volatility	61%	54%
Risk-free interest rate	4.08%	4.02%
Expected life of options	5 years	5 years

Share option activity for the three and six months ended March 31, 2007 is presented below:

Three months ended March 31, 2007	Number of Options	Weighted average exercise price	Expiry Dates
Outstanding – December 31, 2006 (3,571,007 share options exercisable)	4,904,401	$1.34	
Granted	147,251	1.39	
Exercised	(110,855)	0.53	
Forfeited	(36,632)	2.53	
Outstanding – March 31, 2007 (3,618,043 share options exercisable)	4,904,165	$1.35	Apr. 30, 2007 to Sep. 26, 2016

(expressed in Canadian dollars)

Six months ended March 31, 2007	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	147,251	1.39	
Exercised	(110,855)	0.53	
Forfeited	(69,290)	2.16	
Outstanding – March 31, 2007 (3,618,043 share options exercisable)	4,904,165	$1.35	Apr. 30, 2007 to Sep. 26, 2016

11. Research and development

	Three months ended		Six months ended	
	March 31 2007	March 31 2006	March 31 2007	March 31 2006
Research and development costs	$1,530,934	$1,747,274	$3,155,926	$3,492,502
Government grants and funding from third parties under development agreements	(327,661)	(493,629)	(712,226)	(966,278)
	$1,203,273	$1,253,645	$2,443,700	$2,526,224

12. Commitments and contingencies

a) 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 $8,488,172 up to March 31, 2007 (September 30, 2006 - $7,763,007). Of this amount, $7,262,549 (September 30, 2006 - $6,553,246) has been allocated against research and development expenses, $725,623 (September 30, 2006 - $709,761) has been allocated against the cost of property, plant and equipment, and $500,000 (September 30, 2006 - $500,000) is reflected as share purchase warrants. For the three months ended March 31, 2007, $337,297 (March 31, 2006 - $455,514) has been allocated against research and development expenses, and $10,428 (March 31, 2006 - $23,810) has been allocated against the cost of property, plant and equipment.

(expressed in Canadian dollars)

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 March 31, 2007, $116,838 (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. During the three months ended March 31, 2007, $88,052 (March 31, 2006 - $0) has been repaid to the Minister.

13. Segmented information

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

14. Supplemental cash flow information

	Three months ended		Six months ended	
	March 31 2007	March 31 2006	March 31 2007	March 31 2006
Supplemental cash flow information:				
Cash paid for interest	$17,556	$8,956	$28,599	$17,656
Cash received for interest	87,635	41,639	216,071	91,081
Non-cash operating, investing and financing activities:				
Property, plant and equipment included in accrued liabilities	(53,813)		(53,813)	

15. Subsequent events

The Company will be restructuring its operations in the third quarter of fiscal 2007 in order to increase the focus on commercial activities and decrease research and development expenses. Severance costs and termination benefits estimated to total $650,000 are expected to be incurred in the quarter ended June 30, 2007, which will increase general and administrative expenses and decrease cash in the relevant period.