

QuestAir Technologies Inc.

**Third 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 July 31, 2007, relates to our interim financial statements for the three and nine month periods ended June 30, 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 installation and demonstration timeline of the prototype H6200 hydrogen purifier and the resulting timing of receipt of operating data from this prototype; (ii) the expected continued growth in the sale of QuestAir’s gas purifiers in the industrial hydrogen and biogas markets; (iii) management’s belief that biomethane purification represents a significant market for the Company; (iv) QuestAir’s expected performance against the operational and financial milestones for fiscal 2007 including its revenue and cash burn targets; and (v) 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 third quarter of fiscal 2007:

- The prototype H-6200 hydrogen purifier (“prototype plant”), designed for use in the refinery market, was shipped to an ExxonMobil refinery in France. The prototype plant will be installed and tested at this demonstration site in order to generate additional data to assist with the marketing of the H-6200 to other refineries. The prototype plant will be operated under typical refinery conditions throughout the test period, and will remain in on-going use in the refinery following successful completion of the field test.
- QuestAir received an order for a large-scale methane purification system, valued at US\$2.85 million, which will upgrade anaerobic digester gas generated from organic waste to pipeline quality methane. This order demonstrates the growing significance of the biomethane market to QuestAir, with year to date orders from biomethane purification systems accounting for 49% of the total value of gas purification systems sold in the first 9 months of fiscal 2007.
- The Company reorganized its operations during the third quarter in order to focus resources on commercial activities and reduce research and development expenses. Severance and termination benefits totaling approximately \$561,000 are included in general and administrative expenses for the third quarter.

Financial Overview

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

- Revenue was \$3,616,088 for the quarter, increased by \$2,422,708, or 203% compared to the same period in fiscal 2006. Revenue for the nine months was \$6,132,310, increased by \$1,270,813, or 26% from the same period last year.
- Sales order backlog at June 30, 2007 was \$7,135,799, decreased by \$377,027, or 5%, from March 31, 2007, but increased by \$2,091,907, or 41% from September 30, 2006.
- Cash used by operations and capital requirements was \$2,263,565 for the quarter, increased by \$387,414, or 21% compared to the same period in fiscal 2006. Cash used by operations and capital requirements for the nine months was \$7,577,816, compared to \$5,922,222 for the same period in fiscal 2006. At June 30, 2007, we had \$12,207,557 in cash and short term investments, including restricted cash of \$685,308.
- Net loss was \$2,238,859 (\$0.04 per share) for the quarter, increased by \$104,045 or 5% compared to the same period in fiscal 2006. Net loss for the nine months increased to \$8,780,381 (\$0.17 per share) from \$7,538,338 (\$0.19 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 June 30,		Nine months ended June 30,	
	2007	2006	2007	2006
Gas purification systems	3,333,135	573,898	5,613,688	3,277,939
Engineering service contracts	282,953	619,482	518,622	1,583,558
Total revenue	3,616,088	1,193,380	6,132,310	4,861,497

Revenue from the sale of gas purification systems represents a more substantial portion of total revenues than in prior periods, reflecting a change in the nature of our sales order backlog. During the nine months ended June 30, 2007, revenue from the sale of gas purification systems accounted for 92% of total revenue, up from 67% of total revenue during the same period in fiscal 2006.

The increase in revenue from gas purification systems for the quarter and nine months ended June 30, 2007 resulted primarily from revenue being recognized from the sale of a US\$2 million M-3100 system to recover pipeline grade methane from landfill gas at the Rumpke Sanitary Landfill in Cincinnati, Ohio.

Fluctuations in recognized revenue and the receipt of new sales orders are to be expected in the industrial markets that we currently serve. 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 nine months ended June 30, 2007.

(Unaudited)	For the three months ended June 30, 2007			For the nine months ended June 30, 2007		
	Gas Purification Systems	Engineering Service Contracts	Total	Gas Purification Systems	Engineering Service Contracts	Total
Opening Balance	7,078,336	434,491	7,512,827	4,908,298	135,594	5,043,892
Bookings	3,254,422	363,000	3,617,422	7,350,387	901,275	8,251,662
Revenue	(3,333,135)	(282,953)	(3,616,088)	(5,613,688)	(518,622)	(6,132,310)
Adjustments ¹	(339,539)	(38,823)	(378,362)	15,087	(42,532)	(27,445)
Ending Balance	6,660,084	475,715	7,135,799	6,660,084	475,715	7,135,799

The total sales order backlog decreased by \$77,028, or 5%, during the third quarter of fiscal 2007, driven by fluctuations in foreign currency exchange rates. During the quarter, we received an order for an M-3100 system to upgrade anaerobic digester gas generated from organic waste to pipeline quality methane, making a significant contribution to maintaining backlog levels after the recognition of \$3,616,088 in revenue during the quarter. Also during the quarter, we received a small follow-on engineering services contract related to the refinery development program with ExxonMobil Research and Engineering ("EMRE").

Gross Profit

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

(Unaudited)	Three months ended June 30,		Nine months ended June 30,	
	2007	2006	2007	2006
Sales	3,616,088	1,193,380	6,132,310	4,861,497
Cost of goods sold	2,381,958	714,014	5,972,116	3,823,872
Gross Profit	1,234,130	479,366	160,194	1,037,625
Gross Margin (%)	34.1%	40.2%	2.6%	21.3%

The decrease in gross margin for the quarter ended June 30, 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 8% of revenue was from engineering service contracts compared to 52% in the prior period. Engineering service contracts typically contribute higher gross margins. The decrease in gross margin for the nine months ended June 30, 2007 resulted from an estimated loss on the prototype plant being recognized in the second quarter. A further explanation of the loss incurred on this sale can be found in the MD&A for the second quarter of fiscal 2007.

Sales and Marketing

Sales and marketing expenses were \$587,651 for the quarter ended June 30, 2007, increased by 20% compared to \$489,328 for the same period in fiscal 2006. Sales activities increased in the quarter compared to the prior period, resulting in an overall increase in commissions and other

¹ Includes adjustments for fluctuations in foreign currency exchange rates.

sales and marketing expenses. For the nine months ended June 30, 2007, sales and marketing expenses were \$1,615,703, increased by 10% compared to \$1,472,316 for the same period in 2006. This increase is also 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 June 30		Nine months ended June 30,	
	2007	2006	2007	2006
Gross R&D Expenditure	1,561,165	1,640,794	4,717,091	5,133,296
Less: Government & Partner Funding	(320,345)	(404,481)	(1,032,571)	(1,370,758)
Net R&D Expenditure	1,240,820	1,236,313	3,684,520	3,762,538

The 5% and 8% reduction in gross R&D expenditures for the quarter and nine months ended June 30, 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 and nine months 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 \$1,324,820 for the third quarter of fiscal 2007, increased by 71% from \$775,809 for the same period in fiscal 2006. For the nine months ended June 30, 2007, G&A expenses were \$3,151,230, increased by 27% from \$2,475,989 for the same period in 2006. The increase in G&A expenses in the quarter and nine months ended June 30, 2007 resulted primarily from severance costs and termination benefits of \$560,808 related to the restructuring of our operations being recognized in the third quarter. A further explanation of the reorganization can be found in the MD&A for the second quarter of fiscal 2007.

Amortization

Amortization expenses were \$209,647 for the quarter ended June 30, 2007 compared to \$187,360 for the same period in fiscal 2006. The increase relates to the addition of a three-year capital lease for modeling software during the current quarter. For the nine months ended June 30, 2007 amortization was \$641,459 compared to \$951,218 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 \$110,051 for the quarter ended June 30, 2007 compared to income of \$74,630 for the same period in fiscal 2006. Losses from foreign exchange fluctuations and unrealized losses on embedded derivatives were only partially offset by interest income in the quarter ended June 30, 2007. For the nine months ended June 30, 2007 other income was \$152,337 compared to \$86,098 for the same period in fiscal 2006. The increase in other income for the first nine months of fiscal 2007 resulted from higher interest income earned during the period, which was partially offset by losses from foreign exchange fluctuations and unrealized losses on embedded derivatives.

Net Loss

Net loss for the quarter ended June 30, 2007 was \$2,238,859 (\$0.04 per share) compared to \$2,134,814 (\$0.05 per share) for the same period in fiscal 2006. Net loss for the nine months ended June 30, 2007 was \$3,780,381 (\$0.17 per share) compared to \$7,538,338 (\$0.19 per share) for the same period in fiscal 2006. The 16% increase in the net loss for the nine months

was primarily a result of reduced gross profits compared to the prior period, as well as higher G&A expenses associated with the restructuring of our operations in the third quarter.

Loss per share is calculated based on the weighted average number of common shares outstanding in the relevant period. The reduction in the loss per share for the quarter and nine months ended June 30, 2007 was a result of an increase in the weighted average number of common shares outstanding compared to the prior periods (refer to 'Outstanding Share Data').

Capital Expenditures

Capital expenditures net of government funding and proceeds on sale ("Net CAPEX") for the third quarter of fiscal 2007 was \$30,954, compared to \$353,454 for the same period in fiscal 2006. Net CAPEX for the nine months ended June 30, 2007 was \$381,008, compared to \$750,971 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		2006		2005			
	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30
Total Revenues	3,616	873	1,643	2,697	1,193	2,796	872	1,159
Gas Purification Systems	3,333	858	1,423	2,530	574	2,483	221	373
Eng. Service Contracts	283	15	220	167	619	313	651	786
% Gross Margin	34%	(156%)	18%	3%	40%	(7%)	87%	45%
R&D (net)	1,241	1,203	1,240	1,330	1,236	1,253	1,273	1,436
General & Administrative	1,325	987	839	835	776	902	798	917
Net Loss	2,239	4,317	2,225	2,724	2,135	3,336	2,068	2,588
Net Loss per share	(0.04)	(0.08)	(0.04)	(0.05)	(0.05)	(0.09)	(0.06)	(0.06)
Net CAPEX	31	89	261	619	354	66	331	19
Cash used in Operations & Net CAPEX	2,264	1,210	4,105	3,508	1,876	1,724	2,322	2,295
Backlog	7,136	7,513	5,819	5,044	4,976	5,840	5,702	3,008
Gas Purification Systems	6,660	7,078	5,697	4,908	4,570	4,815	4,359	2,240
Eng. Service Contracts	476	435	122	136	406	1,025	1,343	768

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 eight 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.

Fluctuations in G&A expenses are generally due to quarterly variations in stock-based compensation expenses, legal, regulatory and investor relations costs. G&A expenses in current quarter were higher than the prior seven quarters as a result of a restructuring charge (see 'General and Administrative').

Cash Flows, Liquidity and Capital Resources

Cash Flows

Cash and cash equivalents were \$11,461,803 at June 30, 2007, an increase of \$3,337,300 from \$8,124,503 at March 31, 2007. This increase in cash and cash equivalents during the quarter was driven by cash inflows from investing activities of \$5,587,239, partially offset by cash outflows from net operating losses and changes in working capital of \$2,232,611, and from financing activities of \$17,328. Cash and cash equivalents increased \$443,003 for the nine months ended June 30, 2007, as cash inflows from investing and financing activities of \$7,529,593 and \$110,219 respectively exceeded cash outflows from net operating losses and changes in working capital of \$7,196,809.

Cash used by operations for the third quarter of fiscal 2007 was \$2,232,611, compared to \$1,522,697 for the same period in fiscal 2006. The increase in cash used by operations for the quarter was driven by significant changes in non-cash working capital accounts. Deferred revenue decreased \$1,049,258 as revenue recognized in the quarter exceeded new customer deposits on work in progress. The recognition of revenue in the quarter also lowered inventory by \$797,027 in the quarter, as the reallocation to costs of sales from work in progress more than offset inventory purchases during the quarter. For the nine months ended June 30, 2007, cash used by operations was \$7,196,809, compared to \$5,171,251 for the same period in 2006. Higher operating losses and decreases in accounts payable and accrued liabilities were partially offset by increases in deferred revenue compared to the prior period.

Net cash inflow from investing activities for the third quarter of fiscal 2007 was \$5,587,239, compared to a cash outflow of \$7,753,454 for the same period in fiscal 2006. The increase in cash inflows from investing activities for the quarter compared to the same period in 2006 primarily related to the maturity of \$5,000,000 in short-term investments that were converted to cash and cash equivalents. Restricted cash decreased in the current quarter as certain letters of credit to secure customer deposits expired. For the nine months ended June 30, 2007, net cash inflow from financing activities was \$7,529,593, compared to a cash outflow of \$9,263,702 in the same period in fiscal 2006. The increase in cash inflows from investing activities for the nine months related primarily to the maturity of \$7,400,000 in short-term investments made in the prior period that were converted to cash and cash equivalents in the current period. Cash restricted in the prior period decreased in the current period as certain letters of credit to secure customer deposits expired.

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 third quarter of fiscal 2007 was \$2,263,565, compared to \$1,876,151 for the same period in fiscal 2006. Cash used by operations and capital requirements for the nine months ended June 30, 2007 was \$7,577,816, compared to \$5,922,222 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		Nine months ended	
	2007	June 30, 2006	2007	June 30, 2006
Cash used in Operating Activities	(2,232,611)	(1,522,697)	(7,196,809)	(5,171,251)
Add: purchase of property, plant and equipment ("PP&E")	(48,539)	(383,773)	(414,806)	(841,442)
Add: government grants and funding related to PP&E	5,888	29,969	21,751	86,621
Add: proceeds from sale of PP&E	11,697	350	12,048	3,850
Cash used in Operations and Capital Requirements	(2,263,565)	(1,876,151)	(7,577,816)	(5,922,222)

Reconciliation to GAAP Statements of Cash Flow:				
Add: Short-term investments	4,939,554	(7,400,000)	7,339,554	(7,400,000)
Add: restricted cash	678,639	-	571,046	(1,112,731)
Add: Cash from Financing Activities	(17,328)	18,492,100	110,219	18,499,242
Increase in Cash and Cash Equivalents	3,337,300	9,215,949	443,003	4,064,289

The increase in cash burn for the nine months ended June 30, 2007 compared to the same period in fiscal 2006 is primarily due to the increased operating loss, the restructuring charges incurred in the third quarter, and the changes in non-cash working capital in the current period 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 June 30, 2007 cash and short-term investments were \$11,522,249, compared to \$13,124,503 at March 31, 2007. Not included in cash and short-term investments at June 30, 2007 was \$685,308 of restricted cash, which secures customer deposits pending completion 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.

Credit Facilities

During fiscal 2005, we signed a credit facilities agreement with Comerica Bank. This agreement is amended and restated each year as part of the annual renewal of these facilities, most recently in June 2007. The amended credit facilities include a US\$1 million accounts receivable line of credit and a US\$1 million term loan, in addition to \$1,069,762 outstanding under the prior term loan agreements. Both facilities are secured by the assets of the Company with certain exceptions. As at June 30, 2007, we had drawn \$1,054,511 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 June 30, 2007. We expect to fund these expenditures out of our cash reserves:

(Unaudited, \$ '000)	Total	In the next year	2-3 years	Payments due by Period	
				4-5 years	After 5 years
Bank debt	1,054	564	490	-	-
Capital leases	210	105	105	-	-
Operating leases	874	510	282	82	-
Purchase obligations ²	1,789	1,789	-	-	-
Total contractual obligations	3,927	2,968	877	82	-

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.

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 52,530,494 common shares were issued and outstanding as of June 30, 2007, increased by 26,574 or 0.05% from March 31, 2007. 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 June 30,		Nine months ended June 30,	
	2007	2006	2007	2006
Weighted Average Common Shares Outstanding	52,519,392	42,498,492	52,451,434	39,091,486

The average number of common shares outstanding increased for the nine months ended June 30, 2007 compared to the same period in fiscal 2006 as a result of the equity offering in May 2006.

Stock Options and Warrants Outstanding

As at June 30, 2007 there were 4,752,838 stock options and 192,308 share purchase warrants outstanding which collectively could result in the issuance of 4,945,146 common shares if such options and warrants are exercised by the holders in accordance with the terms thereof.

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 France; continued growth in the sales of our commercial gas purification products; and ramping up our order-to-delivery capacity to ensure that we continue to deliver our commercial products on time and on budget.

During the third quarter of fiscal 2007, we shipped the prototype plant to an ExxonMobil refinery in France. The prototype plant is now being installed at the refinery, and we expect to start up the plant in September. In cooperation with refinery staff, following start up of the prototype plant we will conduct a series of tests on the unit over several months, to demonstrate a number of operating conditions which may be encountered at other refineries. Following completion of the test plan, the prototype plant will continue in regular operations at the refinery site.

Our sales of our commercial products have exceeded our expectations this year, due to the rapid growth in the biomethane market. Bookings of our M-3200 and M-3100 products for use in biomethane applications have accounted for nearly half of the total value of equipment orders during the first nine months of the fiscal year. Going forward, we expect to see continued growth in this market, driven by higher natural gas prices and by social and political pressure to generate more energy from renewable sources.

The rapid growth in commercial orders means that we need to expand our manufacturing capacity. We are investing in additional project management and field services resources, and expanding our supply chain in order to meet the growing demand for our products.

Based on financial results for the first nine months of the year, the current status of our sales order backlog and the expected timing of cash receipts and disbursements, management expects that recognized revenue for fiscal 2007 will be within the range of \$7 to \$8 million, and that cash used in operations and capital requirements for the full fiscal year will be between \$10 and \$12 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.

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 contract 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 June 30, 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 June 30, 2007, raw materials on hand of \$798,321 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.

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, embedded 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.

Balance Sheets

	As at June 30, 2007	As at September 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents (note 4)	\$11,461,803	\$11,018,800
Restricted cash (note 5)	685,308	1,256,354
Short-term investments (note 6)	60,446	7,400,000
Accounts receivable	1,677,485	1,476,024
Grants and funding receivables	673,958	454,597
Inventories	3,086,177	3,510,508
Prepaid expenses	261,768	337,335
	<u>17,906,945</u>	<u>25,453,618</u>
Property, plant and equipment	1,887,156	2,103,626
Other long-term assets	169,760	125,000
	<u>\$19,963,861</u>	<u>\$27,682,244</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$3,471,960	\$4,413,717
Deferred revenue	3,086,527	1,946,781
Current portion of bank debt (note 7)	564,306	351,398
Current portion of capital lease obligation	104,764	-
Derivatives (note 8)	90,747	-
	<u>7,318,304</u>	<u>6,711,896</u>
Long term liabilities:		
Bank debt (note 7)	490,205	532,852
Capital lease obligation	104,765	-
	<u>7,913,274</u>	<u>7,244,748</u>
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)	109,359,654	109,020,202
Contributed surplus (note 9b)	6,541,639	6,462,772
Deficit	<u>(103,850,706)</u>	<u>(95,045,478)</u>
	<u>12,050,587</u>	<u>20,437,496</u>
	<u>\$19,963,861</u>	<u>\$27,682,244</u>
Commitments and contingencies (note 12)		

Statements of Operations, Comprehensive Loss and Deficit

	For the three months ended		For the nine months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Revenues	\$3,616,088	\$1,193,380	\$6,132,310	\$4,861,497
Cost of goods sold	2,381,958	714,014	5,972,116	3,823,872
Gross Profit	<u>1,234,130</u>	<u>479,366</u>	<u>160,194</u>	<u>1,037,625</u>
Operating expenses				
Research and development – net (note 11)	1,240,820	1,236,313	3,684,520	3,762,538
General and administration (note 12)	1,324,820	775,809	3,151,230	2,475,989
Sales and marketing	587,651	489,328	1,615,703	1,472,316
Amortization	209,647	187,360	641,459	951,218
	<u>3,362,938</u>	<u>2,688,810</u>	<u>9,092,912</u>	<u>8,662,061</u>
Loss before undernoted	<u>(2,128,808)</u>	<u>(2,209,444)</u>	<u>(8,932,718)</u>	<u>(7,624,436)</u>
Other income (expense)				
Interest income	118,833	90,316	414,965	179,779
Other	(228,884)	(15,686)	(262,628)	(93,681)
	<u>(110,051)</u>	<u>74,630</u>	<u>152,337</u>	<u>86,098</u>
Loss for the period	(2,238,859)	(2,134,814)	(8,780,381)	(7,538,338)
Other comprehensive income	-	-	-	-
Comprehensive loss for the period (note 9d)	(2,238,859)	(2,134,814)	(8,780,381)	(7,538,338)
Deficit – Beginning of period	(101,611,847)	(90,186,084)	(95,045,478)	(84,782,560)
Unrealized foreign exchange loss on derivatives (note 9c)	-	-	(24,847)	-
Deficit – End of period	<u>\$(103,850,706)</u>	<u>\$(92,320,898)</u>	<u>\$(103,850,706)</u>	<u>\$(92,320,898)</u>
Basic and diluted loss per share	\$(0.04)	\$(0.05)	\$(0.17)	\$(0.19)
Weighted average number of common shares outstanding	52,519,392	42,498,492	52,451,434	39,091,486

Statements of Cash Flows

	For the three months ended		For the nine months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Cash flows from operating activities				
Loss for the period	\$(2,238,859)	\$(2,134,814)	\$(8,780,381)	\$(7,538,338)
Items not involving cash				
Amortization	209,647	187,360	641,459	951,218
Gain on sale of property, plant and equipment	(2,214)	(350)	(2,564)	(8,424)
Unrealized foreign exchange loss on derivatives (note 8)	56,059	-	65,899	-
Non-cash compensation expense	104,986	127,101	350,434	373,591
Foreign currency loss (gain)	(18,605)	-	(18,605)	503
	<u>(1,888,986)</u>	<u>(1,820,703)</u>	<u>(7,743,758)</u>	<u>(6,221,450)</u>
Changes in non-cash operating working capital				
Accounts, grants and funding receivables	(276,679)	976,076	(420,822)	463,330
Inventories	797,027	(584,676)	424,331	(197,881)
Prepaid expenses	127,697	(178,503)	30,806	(215,202)
Accounts payable and accrued liabilities (note 14)	57,588	635,126	(627,112)	1,146,080
Deferred revenue	(1,049,258)	(550,017)	1,139,746	(146,128)
	<u>(343,625)</u>	<u>298,006</u>	<u>546,949</u>	<u>1,050,199</u>
	<u>(2,232,611)</u>	<u>(1,522,697)</u>	<u>(7,196,809)</u>	<u>(5,171,251)</u>
Cash flows from investing activities				
Decrease (increase) in short-term investments	4,939,554	(7,400,000)	7,339,554	(7,400,000)
Purchase of property, plant and equipment (note 14)	(48,539)	(383,773)	(414,806)	(841,442)
Government grants and funding related to property, plant and equipment	5,888	29,969	21,751	86,621
Proceeds on sale of property, plant and equipment	11,697	350	12,048	3,850
Decrease (increase) in restricted cash	678,639	-	571,046	(1,112,731)
	<u>5,587,239</u>	<u>(7,753,454)</u>	<u>7,529,593</u>	<u>(9,263,702)</u>
Cash flows from financing activities				
Issuance of common shares	-	20,000,250	-	20,000,250
Share issue costs	-	(1,497,328)	-	(1,497,328)
Issuance of common shares on exercise of stock options	9,097	5,064	67,885	84,486
Issuance of bank debt	214,254	153,446	462,759	153,446
Repayment of bank debt	(112,749)	(58,472)	(292,495)	(130,752)
Repayment of obligations under capital lease	(127,930)	(110,860)	(127,930)	(110,860)
	<u>(17,328)</u>	<u>18,492,100</u>	<u>110,219</u>	<u>18,499,242</u>
Increase in cash and equivalents	3,337,300	9,215,949	443,003	4,064,289
Cash and equivalents – Beginning of period	8,124,503	5,262,559	11,018,800	10,414,219
Cash and equivalents – End of period	\$11,461,803	\$14,478,508	\$11,461,803	\$14,478,508
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 June 30, 2007, has an accumulated deficit of \$103,850,706. 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 June 30, 2007 and the unaudited interim statements of operations, comprehensive loss and deficit and cash flows for the nine months ended June 30, 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 nine months ended June 30, 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 term deposits 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

The Company is 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 February 28, 2009. In addition, TD Bank required a restricted deposit to secure corporate credit card debt; however, this requirement was removed as of May 15, 2007. Restricted cash at June 30, 2007 of \$685,308 (September 30, 2006 - \$1,256,354) relates to letters of credit of \$682,308 (September 30, 2006 - \$1,196,889) and corporate credit card security of \$nil (September 30, 2006 - \$59,465).

6. Investments

The Company's investments consist of term deposits, 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. Bank debt

In April 2005, the Company signed a credit facilities agreement with Comerica Bank. This agreement was amended and restated in June 2007 as part of the annual renewal of these facilities. The amended credit facilities include a US\$1 million accounts receivable line of credit and a US\$1 million term loan to finance equipment purchases, in addition to amounts outstanding under prior term loan agreements. Both facilities 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 June 30, 2007, the Company had drawn \$1,054,511 (September 30, 2006 - \$884,250) on prior term loans, net of repayments. Accrued interest payable as at June 30, 2007 was \$2,510 (September 30, 2006 - \$3,399). Total interest expense was \$15,481 (June 30, 2006 - \$11,007) for the quarter ended June 30, 2007. As at June 30, 2007, no draws had been made under the amended credit facilities. Draws can be made against the term loan prior to June 21, 2008.

8. 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 June 30, 2007 is a \$56,059 unrealized foreign exchange loss on such embedded derivatives, and \$65,899 for the nine months ended June 30, 2007.

9. Shareholders' Equity

Changes to shareholders' equity for the three and nine months ended June 30, 2007 are presented below:

QuestAir Technologies Inc.
Unaudited Interim Financial Statements
June 30, 2007 and 2006
(expressed in Canadian dollars)



For the three months ended June 30, 2007						
	Common Shares	Contributed Surplus	Accumulated Other Comprehensive Income (Loss)	Deficit	Total Shareholders' Equity	Comprehensive Loss
March 31, 2007	\$109,293,375	\$6,493,835	-	\$(101,611,847)	\$14,175,363	-
Net Loss	-	-	-	(2,238,859)	(2,238,859)	\$(2,238,859)
Total comprehensive loss	-	-	-	-	-	\$(2,238,859)
Exercise of share options	9,097	-	-	-	9,097	-
Stock-based compensation allocated to common shares on exercise of share options	57,182	(57,182)	-	-	-	-
Stock-based compensation on fair value share options	-	104,986	-	-	104,986	-
June 30, 2007	\$109,359,654	\$6,541,639	-	\$(103,850,706)	\$12,050,587	-

For the nine months ended June 30, 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	-	-	-	(8,780,381)	(8,780,381)	\$(8,780,381)
Adjustment to opening balance of unrealized foreign exchange loss on derivatives	-	-	-	(24,847)	(24,847)	-
Total comprehensive loss	-	-	-	-	-	\$(8,780,381)
Exercise of share options	67,885	-	-	-	67,885	-
Stock-based compensation allocated to common shares on exercise of share options	271,567	(271,567)	-	-	-	-
Stock-based compensation on fair value share options	-	350,434	-	-	350,434	-
June 30, 2007	\$109,359,654	\$6,541,639	-	\$(103,850,706)	\$12,050,587	-

a) Common shares – issued and outstanding

Authorized share capital consists of an unlimited number of common shares of which 52,530,494 common shares were issued and outstanding as of June 30, 2007. During the three months ended June 30, 2007, 26,574 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 June 30, 2007 \$104,986 (June 30, 2006 - \$127,101) 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 to the balance of retained earnings 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. (Also see note 8)

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 \$2,238,859 for the quarter ended June 30, 2007 and \$8,780,381 for the nine months ended June 30, 2007.

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 (“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 June 30, 2007, 1,025,336 (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 has been issued under the 2006 Plan as at June 30, 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 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:

	Nine months ended	
	June 30 2007	June 30 2006
Dividend yield	0%	0%
Expected volatility	60%	54%
Risk-free interest rate	4.09%	4.04%
Expected life of options	5 years	5 years

Share option activity for the three and nine months ended June 30, 2007 is presented below:

Three months ended June 30, 2007	Number of Options	Weighted average exercise price	Expiry Dates
Outstanding – March 31, 2007 (3,618,043 share options exercisable)	4,904,165	\$1.35	
Granted	15,000	1.21	
Exercised	(26,574)	0.34	
Forfeited	(139,753)	1.61	
Outstanding – June 30, 2007 (3,736,139 share options exercisable)	4,752,838	1.34	Jul. 31, 2007 to Sep. 26, 2016

Nine months ended June 30, 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	162,251	1.37	
Exercised	(137,429)	0.49	
Forfeited	(209,043)	1.79	
Outstanding – June 30, 2007 (3,736,139 share options exercisable)	4,752,838	1.34	Jul. 31, 2007 to Sep. 26, 2016

11. Research and development

	Three months ended		Nine months ended	
	June 30 2007	June 30 2006	June 30 2007	June 30 2006
Research and development costs	\$1,561,165	\$1,640,794	\$4,717,091	\$5,133,296
Government grants and funding from third parties under development agreements	(320,345)	(404,481)	(1,032,571)	(1,370,758)
	<u>\$1,240,820</u>	<u>\$1,236,313</u>	<u>\$3,684,520</u>	<u>\$3,762,538</u>

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 \$8,814,405 up to June 30, 2007 (September 30, 2006 - \$7,763,007). Of this amount, \$7,582,894 (September 30, 2006 - \$6,553,246) has been allocated against research and development expenses, \$731,511 (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 June 30, 2007, \$320,344 (June 30, 2006 - \$452,449) has been allocated against research and development expenses, and \$5,889 (June 30, 2006 - \$29,969) 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 June 30, 2007, \$154,584 (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.

- b) Severance and termination benefits

The Company restructured its operations during the quarter ended June 30, 2007 in order to increase the focus on commercial activities and decrease research and development expenses. Severance costs and termination benefits included in general and administration expenses total \$560,808, of which \$458,474 has been paid, and \$102,334 is payable prior to the end of the fiscal 2008.

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		Nine months ended	
	June 30 2007	June 30 2006	June 30 2007	June 30 2006
Supplemental cash flow information:				
Cash paid for interest	\$14,755	\$16,558	\$43,354	\$34,214
Cash received for interest	292,278	58,418	508,349	149,499
Non-cash operating, investing and financing activities:				
Property, plant and equipment included in accrued liabilities	(10,388)	-	(314,645)	-