

SUBJECT: QuestAir Technologies Inc.

DATE: Annual Report 2006

HIGHLIGHTS FOR 2006

- QuestAir's joint program with ExxonMobil Research and Engineering Company (EMRE) passed a critical ExxonMobil review, **authorizing final funding for the construction of a prototype H-6200 hydrogen purifier to be demonstrated at an ExxonMobil refinery in 2007.**
- Agreement signed with EMRE to jointly market the H-6200 hydrogen purifier to third-party customers in the oil refining market.
- Revenue growth of 20% to \$7.6 million.
- 68% growth in sales order backlog to \$5.0 million at year end.
- Cash used in operations and capital expenditures of \$9.4 million (2005: \$8.7 million).
- Sold first M-3100 methane purification system in the biogas market. The system will recover pipeline-grade methane from landfill gas at the Rumpke Sanitary Landfill in Cincinnati, Ohio.
- Signed licensing agreement for H-3100 hydrogen purifiers with Hydro-Chem, a leading hydrogen plant vendor. *Important new distribution partner*
- Successful equity offering raising net proceeds of approximately \$18.4 million.
- Strengthened patent portfolio to 49 patents and 101 applications pending, covering 26 distinct inventions.

Demand for technology to grow > pg. 6

QUESTAIR'S TECHNOLOGY MAY SEEM COMPLICATED, BUT ITS IMPACT IS NOT.

Simply put: QuestAir is playing a growing role in energy production and industrial processes worldwide. We are delivering year-over-year revenue growth through sales of our proprietary gas purification systems. We are also developing new products that will play a vital role in the oil refining industry. And, we're helping to feed the growing global appetite for more sustainable alternatives to fossil fuels.

The more you learn about QuestAir, the more you realize we are a company positioned for great growth today, and tomorrow.

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MD&A

Auditor's Report

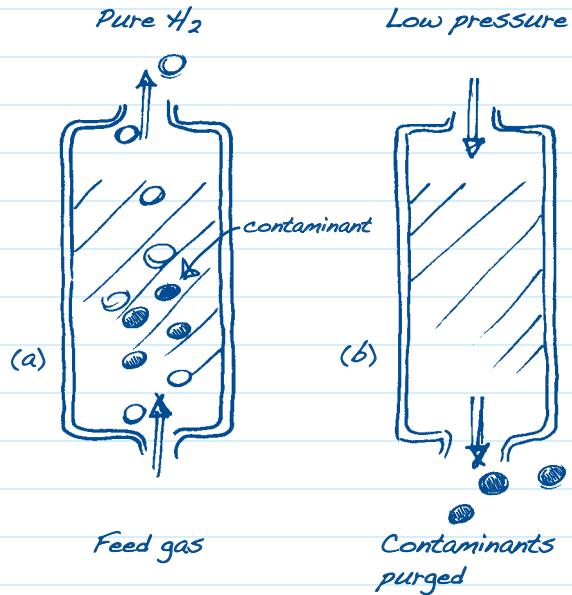
Consolidated Financial Statements

Notes to Consolidated Financial Statements

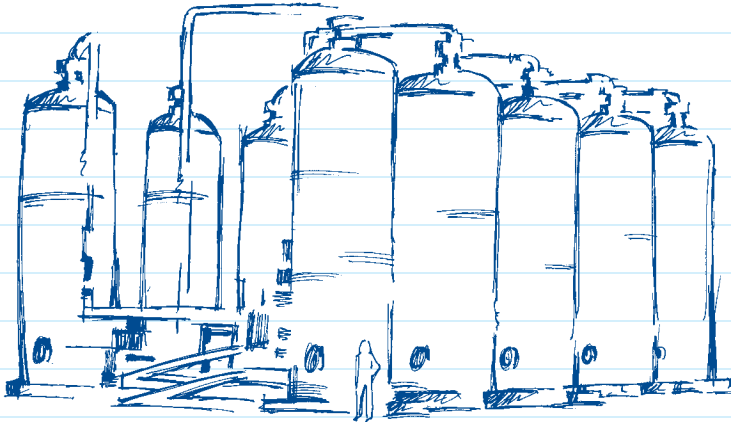
SCIENCE:

How PSA works

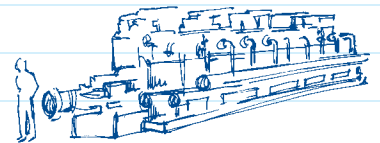
- (a) Under pressure, adsorbent beds catch contaminants like carbon monoxide and dioxide, producing purified hydrogen.
- (b) When pressure is reduced, the impurities are released, refreshing the bed for another cycle.



conventional
PSA plant



QuestAir's rapid-cycle
PSA is less than
1/10 the size of
conventional systems



- QuestAir has sold more than 75 PSA systems to customers in Europe, North America and Asia. Our customers include industry leaders like Chevron, The Linde Group and Mitsubishi.
- QuestAir's PSA systems have logged over 450,000 operating hours under demanding commercial conditions. Commercial uptime on our systems has exceeded 99%.
- QuestAir's proprietary technology is protected by a patent portfolio of 49 patents and 101 applications pending, covering 26 distinct inventions.

PSA used in industry since the 1960s

1. What is PSA technology?

QuestAir's technology makes advancements on a proven gas separation and purification process called pressure swing adsorption (PSA). PSA is used extensively in the production and purification of oxygen, nitrogen and hydrogen for industrial uses. PSA is based on the capacity of certain materials to adsorb and remove particular gases as pressure is raised and lowered. PSA can be used to separate a single gas from a mixture of gases. A typical PSA system involves a number of connected vessels containing adsorbent material that undergo several pressurization and depressurization steps to produce a continuous stream of purified gas.

2. Why does PSA technology matter?

PSA technology is used to purify gases that are critical to a wide range of industries. PSA is a key part of many industrial processes that produce the energy, fuels and materials that we use every day. QuestAir's primary focus is hydrogen purification and recovery for use in oil refining, and in a range of other industries, including chemical production, metal refining, food processing and electronics manufacturing. QuestAir's PSA technology is also being used to recover methane fuel from renewable sources such as biogas.

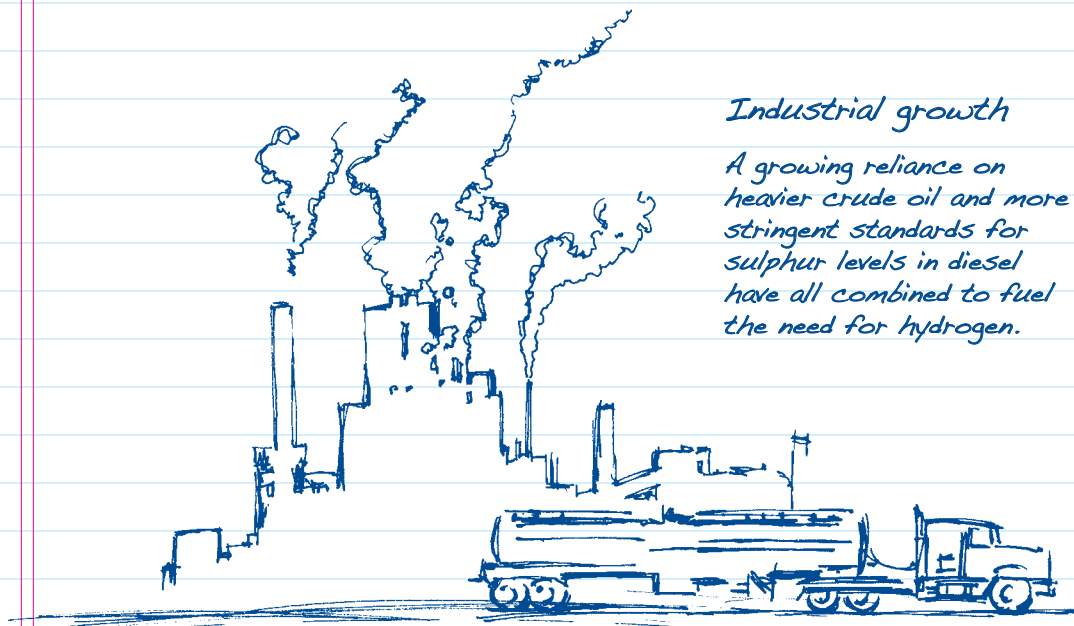
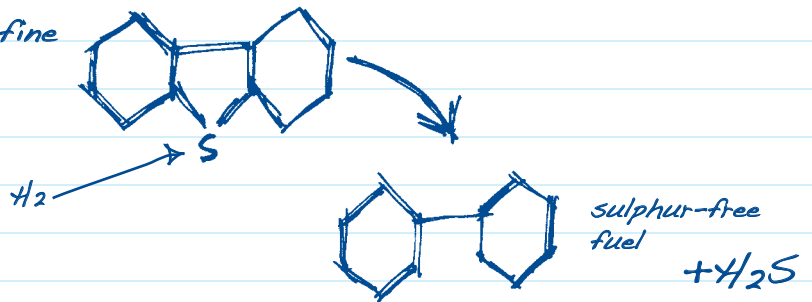
3. Why is QuestAir's PSA technology better?

QuestAir's patented PSA is superior to traditional technology because it is simpler, more compact and costs less. It's simpler and more reliable because our patented rotary-valves replace the numerous switching valves used in conventional PSA. It's more compact because our proprietary structured adsorbents allow us to run much faster PSA cycles. Our PSA systems can be up to 1/10 the size of conventional PSA, helping to save space and reduce capital costs. In addition, our modular, skid-mounted systems are easier and more cost effective to install. By changing the type of adsorbent material, we can easily purify a range of different gases, including hydrogen, methane and helium.

CHEMISTRY:

Hydrogen used to refine crude oil

Hydrogen removes contaminants during the refining process, including typical sulphur-containing molecules in diesel.



Industrial growth

A growing reliance on heavier crude oil and more stringent standards for sulphur levels in diesel have all combined to fuel the need for hydrogen.

- Annual global hydrogen production is approximately 50 million tons.
- Approximately 30% of worldwide hydrogen production is used in the oil refining industry.
- Current hydrogen consumption in oil refining ranges from 300-500 cubic feet per barrel.

1. What is hydrogen?

While QuestAir's PSA technology is being applied to a variety of gases, our prime area of focus is hydrogen. Hydrogen is a gas that is lighter than air and exists in its natural state as H₂. A hydrogen atom consists of one proton and one electron and is the first element on the periodic table. At room temperature, hydrogen is a gas; when cooled to very low temperatures it becomes a liquid. Most importantly, hydrogen plays a prevalent role in a variety of industrial and chemical processes that drive our modern economy.

2. How is hydrogen produced?

Approximately 95% of hydrogen currently consumed worldwide is generated from natural gas or other hydrocarbon fuels such as coal. Hydrogen is also recovered from hydrogen-containing gas streams that are produced as a by-product of the oil refining process. QuestAir technology plays a big role in both supply routes. In other industrial processes such as metal refining, food processing and electronics manufacturing, hydrogen is delivered to customers either in compressed or liquid form, or generated from natural gas at the customer site. QuestAir's PSA systems are used in these so-called "on site" hydrogen plants.

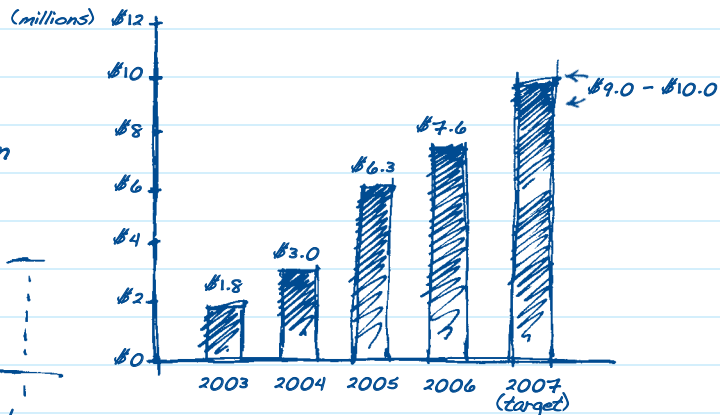
3. Where is hydrogen used?

Hydrogen is used to create products that are essential to our lives, including fertilizer for use in agriculture, and methanol, an important feedstock in the chemicals industry. Hydrogen is also used extensively to refine crude oil into fuels such as gasoline and diesel. Hydrogen removes contaminants, such as sulphur, during the refining process to meet strict environmental and quality standards for today's transportation fuels. Hydrogen is also used in the processing of heavy forms of crude oil such as oil sands, breaking these heavy oils down into lighter, more useful petroleum products.

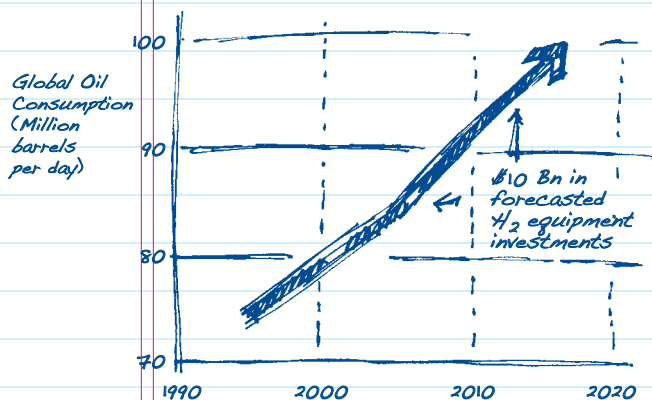
← Poorer quality crude oil requires more hydrogen

ECONOMICS:

QuestAir recognized revenue



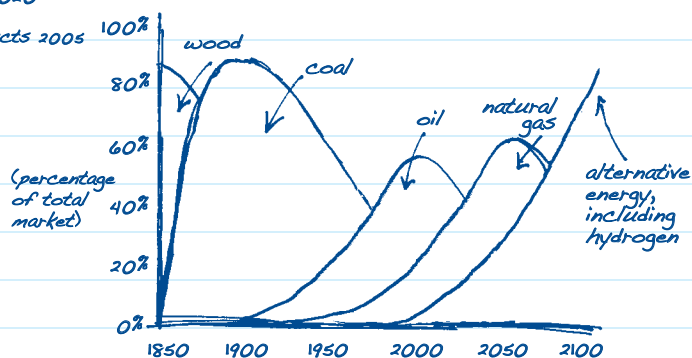
Market for H_2 equipment in oil refining industry *



* International Energy Outlook 2004; Air Products 2005

Supply pressures in the oil refining sector are spurring investment in hydrogen. QuestAir is realizing year-over-year revenue growth and is strongly positioned for the future as alternative energy sources are developed.

Emergence of hydrogen as a fuel*



* Source: Marchetti and Nakicenovic

- Demand for crude oil is expected to grow from approximately 80 million barrels per day today to over 100 million barrels per day by 2015.
- Hydrogen demand in oil refining is expected to grow by up to 10% per annum through to 2010. Hydrogen consumption per barrel of oil may increase as high as 800-1,000 cubic feet per barrel as refineries meet ultra-low sulphur diesel regulations and process heavier crude oil stocks.
- Investment in new hydrogen generation equipment in the oil refining sector could reach US\$10 billion between 2005 and 2015.

1. Why is demand for hydrogen escalating in the oil refining industry?

Industrial growth - led by the emerging BRIC economies of Brazil, Russia, India and China - is increasing world demand for oil. As demand increases, so too does the need for hydrogen used to refine this oil into useful products. Higher oil prices also mean that heavy crudes and tar sands, once uneconomic to produce, are now a growing source of new oil supply. These heavy oils require higher volumes of hydrogen in the refining process. Stricter environmental regulations across the world are also forcing oil refineries to use more hydrogen to remove contaminants from the fuels they produce.

Oil sands production forecasted to go from 1M b/d to 4M by 2020

2. How is QuestAir positioned to meet this demand?

Market pressures will drive demand for PSA systems for large capacity hydrogen plants and for recovering hydrogen in oil refineries. QuestAir is strongly positioned in the industry. We are currently developing our next generation PSA system - the QuestAir H-6200 - in collaboration with ExxonMobil Research and Engineering for use in a range of refinery applications. The H-6200 is a significant advancement in hydrogen recovery for the oil industry and can significantly improve the economics of hydrogen supply in refineries around the world.

Prototype H-6200 will be demonstrated at ExxonMobil refinery in 2007

3. What are QuestAir's future markets?

The lasting impact of climate change is now front-page news. The search for cleaner fuel technology continues, including the use of hydrogen fuel cells to power vehicles, homes and buildings. Supplying hydrogen as fuel for fuel cells requires technology to separate and purify hydrogen from the original fuel source, which is commonly natural gas. QuestAir has supplied 14 PSA systems to demonstration hydrogen fuelling stations in the U.S., Canada and Asia. We are also working with ExxonMobil Research and Engineering to develop a compact "on-board" hydrogen generator for use in a range of fuel cell powered vehicles.

REVIEW OF 2006 MILESTONES:

1. Pass final ExxonMobil program review and receive purchase orders for prototype large capacity hydrogen PSA.

The ExxonMobil program review was successfully passed in April 2006, authorizing final funding for the prototype construction and testing. QuestAir received purchase orders totaling \$4.3 million during fiscal 2006 towards the prototype plant construction.

2. Complete fabrication and shipment of the large capacity hydrogen PSA to ExxonMobil refinery.

The final purchase order for the prototype H-6200 was received in the fourth quarter of fiscal 2006, extending the completion of the prototype fabrication to around the end of calendar 2006, with shipment to follow shortly thereafter.

3. Sign agreement with EMRE for marketing of large capacity hydrogen PSA in the oil refining industry.

In May 2006, we signed an agreement with EMRE to jointly market the H-6200 hydrogen purifier to third-party customers in the oil refining market.

4. Sign agreement to extend large capacity PSA product platform into new market.

During fiscal 2006, we completed an initial contract with EMRE to assess the use of the H-6200 technology platform of the processing of sub-quality or "sour" natural gas. Options for further funded work in this area, or in other petrochemical markets are currently being assessed, with a formal agreement expected to follow in fiscal 2007.

5. Sign an additional distribution agreement for QuestAir's first generation gas purification products with a leading hydrogen plant vendor.

In March 2006, we signed a licensing agreement with Hydro-Chem, a leading global supplier of industrial hydrogen plants. QuestAir's H-3100 hydrogen purifier will be included as a standard offer in Hydro-Chem's product line.

President's Message

2006 was a year of very solid progress for QuestAir. Growth in revenue and in our backlog of signed customer contracts was strong for the year, and we made key progress towards the commercialization of our H-6200 hydrogen purifier in the oil refining market with ExxonMobil Research and Engineering (EMRE). We are planning to demonstrate a commercial-scale H-6200 system at an ExxonMobil refinery in Europe starting in early calendar 2007, and we have begun to aggressively market the product to oil refinery customers under a marketing agreement signed with EMRE during the year.

In the commercial area, we successfully expanded the vertical markets for our first generation gas purification products, most notably with our first sale of a M-3100 methane recovery system in the growing biogas market. We also expanded the distribution channels for our commercial products through the licensing and supply agreements signed with Hydro-Chem and Nuvera Fuel Cells respectively.

Our financial results for fiscal 2006 were in line with our expectations, and the financial guidance that we provided for the year. Revenues from the sale of gas purification systems and engineering service contracts grew by 20% to \$7.6 million, in line with our revenue guidance of \$7.5 million for the fiscal year. Our sales order backlog at year end was \$5.0 million, an increase of 68% from \$3.0 million at September 30, 2005. Cash used in operations and capital requirements was \$9.4



million for the year, in line with our cash burn guidance of \$8.5-\$9.5 million for the fiscal year. Our net loss for the year was \$10.2 million (\$0.24 per share), compared to \$9.5 million (\$0.31 per share) for fiscal 2005.

Operating Review and 2006 Milestone Update

A number of achievements were made in the program being undertaken with EMRE to develop the H-6200 hydrogen purifier for refinery and petrochemical applications. In April 2006 the program passed a critical internal ExxonMobil review, authorizing final funding to complete the construction and testing of a prototype H-6200 hydrogen purifier at an ExxonMobil refinery

“Revenues from the sale of gas purification systems and engineering service contracts grew by 20%.”

located in Europe. During fiscal 2006 we received purchase orders from ExxonMobil totaling \$4.3 million related to the prototype construction. The timing of a key purchase order from ExxonMobil extended the construction of the prototype plant into the fourth quarter of calendar 2006. Based on the current project plan, we expect to ship the prototype early in the first quarter of calendar 2007, with installation and startup at the ExxonMobil refinery being completed during the first half of calendar 2007.

We also signed a marketing agreement with EMRE which covers the marketing of the H-6200 hydrogen purifier to third-party customers in the oil refining industry. The agreement outlines the roles that each party will play in the marketing process, and how the commercial gains from the sales of the product will be shared between QuestAir and EMRE. Following the signing of this agreement, we began jointly marketing and promoting the H-6200 with EMRE, and currently we are responding to a number of commercial enquiries from both ExxonMobil and third-party refineries.

We completed an initial research contract with EMRE to assess

the use of the H-6200 platform technology for the processing of contaminated or “sour” natural gas. This contract was significant in demonstrating the potential application of the product platform to other high-value markets outside of oil refining. Options for the next phase of this development work are currently being assessed.

During the year, we made a number of breakthroughs in the sale of our commercial first generation gas purification products. During fiscal 2006, we sold our first M-3100 methane recovery system, valued at approximately US\$2 million, into the landfill gas processing market. The M-3100 system will upgrade landfill gas generated at the Rumpke Sanitary Landfill near Cincinnati, Ohio, generating high purity methane for injection into the natural

gas distribution network. This initial sale into the landfill gas market follows a successful demonstration of a M-3100 system at the Vancouver Landfill site which was undertaken during the year. In the industrial hydrogen market, we successfully started up two H-3100 hydrogen purifiers installed at the HydroEdge liquid hydrogen plant in Osaka, Japan. These

are the largest capacity commercial hydrogen purifiers that we have operated to date, demonstrating the expansion of our commercial product line into the intermediate capacity range of the hydrogen plant market.

We also made significant progress in expanding the distribution channels for our first

generation products. We signed a manufacturing licensing agreement with Hydro-Chem LLC, a division of The Linde Group, and a leading manufacturer of hydrogen plants in the intermediate capacity range. Under the terms of the agreement, the H-3100 hydrogen purifier will be included in Hydro-Chem’s industrial hydrogen plants, expanding our access to the intermediate capacity segment of the hydrogen plant market.

We maintained our position as the leading supplier of hydrogen purification systems in the emerging hydrogen infrastructure market. During the year, we received orders for five H-3200 hydrogen purifiers for hydrogen fueling stations located in Canada, the United States and Korea. At year-end, we had sold 14 hydrogen purifiers into the hydrogen

“During the year, we made a number of breakthroughs in the sale of our commercial first generation gas purification products.”

infrastructure market. We also signed an agreement, valued at up to US\$700,000 over 2 years, to supply our small capacity H-3300 hydrogen purifiers to Nuvera Fuel Cells. The H-3300 will be incorporated into Nuvera's PowerTap™ hydrogen generators, which will be marketed as a distributed source of hydrogen fuel to support fuel cell powered vehicles such as fork lifts and airport ground support vehicles.

Early in the fiscal year, we received a \$1.4 million engineering services contract from EMRE to complete the second phase of a program to develop a compact on-board hydrogen generator for use in a range of transportation applications. Target markets for this product include potential early term fuel cell markets such as utility vehicles and auxiliary power units for heavy duty trucks and military vehicles.

A complete review on our progress towards our 2006 milestones is presented on page 8 of this report.

2007 Milestones

Each year we set a number of operational milestones to map our anticipated progress over the coming year, and to provide our investors with a means to evaluate our performance toward creating shareholder value. Our milestones for 2007 are:

1. Complete the installation and startup of the prototype H-6200 hydrogen purifier at an ExxonMobil refinery.

We expect that the prototype H-6200 hydrogen purifier will be installed and started up at the ExxonMobil refinery during the first half of calendar 2007.

2. Receive the first purchase order for a commercial H-6200 hydrogen purifier.

EMRE and QuestAir are actively marketing the H-6200 to both ExxonMobil and third-party refineries, with the objective of securing a purchase order for the first commercial sale during fiscal 2007.

3. Sign an agreement to extend the H-6200 platform technology into a new market.

QuestAir has entered into a number of preliminary engineering contracts to assess the application of the H-6200 platform technology into additional markets such as natural gas processing and other separations in the petrochemical industry. Based on the outcome of these preliminary studies, we aim to sign an agreement to undertake the next phase of this product development.

4. Secure first purchase order for a methane purification system in the European biogas market.

There is significant interest in Europe in the use of renewable sources of methane to supplement imported natural gas, and as a carbon neutral source of transportation fuel for buses and cars. During the year, we expect to sell our first system in the European market to recover high purity methane from biogas.

5. Increase recognized revenue to between \$9 and \$10 million.

Total recognized revenue is expected to be between \$9 and \$10 million in fiscal 2007, representing an increase of approximately 19% to 32% from \$7.6 million in fiscal 2006. We expect revenue growth from both our

first generation commercial products and anticipated engineering service contracts. Any commercial H-6200 orders received during fiscal 2007 are not expected to be recognized as revenue during fiscal 2007 given the expected manufacturing and installation time of these large units.

6. Manage cash used in operations and capital expenditures to between \$7 and \$8 million.

Cash used in operations and capital expenditures is expected to be in the range of \$7 to \$8 million, reduced from \$9.4 million in fiscal 2006. Expenditures on both the commercialization of the H-6200 product, as well R&D activities related to the extension of the H-6200 platform technology into new markets are expected to continue through fiscal 2007.

Fiscal 2007 will be a landmark year for QuestAir with the commercialization of our H-6200 hydrogen purifier in the oil refining market. This product provides oil refineries with a solution to the growing demand for hydrogen in oil refining, as well as offering a unique tool to increase refinery productivity and profitability. As such, we expect the H-6200 to be the key catalyst to drive QuestAir to profitability and beyond.

Our major objectives for the coming year include the installation and startup of the prototype H-6200 hydrogen purifier at an ExxonMobil refinery, and the subsequent first sale of a fully commercial H-6200 system in the oil refining market. We also expect to see continued growth in the sale of our first generation gas purifiers in the industrial hydrogen and biogas markets.

As always, the progress that we have made over the year would not have been possible without the dedication and hard work of our employees. I would like to thank all of our employees for their commitment and for the high quality of work consistently delivered through the year.

I look forward to reporting to you over the next year on our accomplishments and milestones achieved.

Sincerely,



Jonathan Wilkinson
President and CEO

ACCOUNTING

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MANAGEMENT'S DISCUSSION AND ANALYSIS

For Year Ended September 30, 2006

The following management discussion and analysis ("MD&A"), dated December 5th, 2006 (with the exception of the 'Outstanding Share Data', which is dated November 30, 2006) should be read in conjunction with the Company's audited consolidated financial statements and related notes therein that are prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). Following a change in the rules governing the AIM Market of the London Stock Exchange Plc on August 22, 2006, which recognized Canadian GAAP as an acceptable reporting standard, we are no longer required to provide a reconciliation of our financial results to those that would be reported under United States generally accepted accounting principles ("US GAAP"). Consequently, a reconciliation to US GAAP is not provided in the notes to the financial statements for the fiscal year ended September 30, 2006. All financial information is stated in Canadian dollars, unless otherwise stated. Additional information regarding QuestAir Technologies Inc. ("QuestAir" or "the Company"), can be found on the System for Electronic Document Analysis and Retrieval (SEDAR) at www.sedar.com.

FORWARD LOOKING STATEMENTS

This MD&A contains forward-looking statements, including statements regarding the future success of our business, technology, and market opportunities. Forward-looking statements typically contain words such as "believes", "expects", "anticipates", "continue", "could", "indicates", "plans", "will", "intends", "may", "projects", "schedule", "would" or similar expressions suggesting future outcomes or events, although not all forward-looking statements contain these identifying words. Examples of such statements include, but are not limited to, statements concerning: (i) management's belief that its second generation PSA technology will offer further reductions in size and cost relative to current commercial products; (ii) the expected shipment, installation and demonstration timeline of a commercial-scale prototype of the H-6200 hydrogen purifier; (iii) the market drivers that will have an important impact on QuestAir's long term prospects and ability to create shareholder value as described herein; (iv) forecast demand for hydrogen in the refining of crude oil; (v) forecast growth of hydrogen consumption per barrel of oil and the expected drivers of this growth; (vi) the growth opportunities that will be created for the H-6200 hydrogen purifier as a result of certain macroeconomic drivers specified herein, and the related expected growth in revenue; (vii) the expectation that fiscal 2007 will be a landmark year for QuestAir with the commercialization of its H-6200 hydrogen purifier in the oil refining market; (viii) the expected continued growth in the sale of QuestAir's first generation gas purifiers in the industrial hydrogen and biogas markets; (ix) QuestAir's expected performance against the operational and financial milestones for fiscal 2007 as described herein; 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 Management Discussion and Analysis 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.

OUR VISION, STRATEGY AND CORE BUSINESS

Vision and Strategy

QuestAir's strategic goal is to become a leader in the development, manufacture and supply of pressure swing adsorption ("PSA") gas purification systems for refinery, industrial, energy and fuel cell markets. Our strategy to achieve this goal has the following key elements:

1. Reach profitability through sales into existing industrial and refining markets;
2. Leverage key relationships with market leaders such as ExxonMobil Research and Engineering ("EMRE"), and Shell Hydrogen;
3. Pursue opportunities that leverage QuestAir's product platforms;
4. Play an active role in the emerging hydrogen economy; and
5. Pursue disciplined cash management.

Core Business

QuestAir is an emerging developer and supplier of advanced gas purification systems. Our products target a range of existing energy and industrial markets, including oil refining, natural gas processing and biogas processing, as well as emerging markets such as hydrogen fueling stations that support fuel cell powered vehicles.

Our compact, modular gas purification products incorporate proprietary PSA technology, and offer significant economic and operational benefits over conventional PSA technology, including reduced capital, installation and operating costs. Our proprietary technology is protected by a patent portfolio including 49 patents covering 26 distinct inventions and 101 patent applications.

QuestAir has approximately 85 employees located at our facility and corporate headquarters in Burnaby, British Columbia, Canada. We market and support our products on a global basis from our Burnaby location.

Products, Markets & Customers

Commercial Products: We currently sell a range of commercial PSA systems for use in small-scale on-site hydrogen plants for industrial markets, biogas processing and demonstration hydrogen stations for refueling fuel cell vehicles. Since 1997 we have sold more than 75 PSA systems to over 30 customers in North America, Asia and Europe.

We market and distribute our products directly to customers, but we also have non-exclusive distribution agreements with leading hydrogen plant vendors including Iwatani International, Mitsubishi Kakoki Kaisha and KTI Technip, and an agreement to supply our H-3200 hydrogen purifiers to HyRadix Inc, a leading developer of hydrogen generators for industrial and hydrogen fueling markets. In 2006 we signed a manufacturing license agreement for our H-3100 hydrogen purifiers with Hydro-Chem, a leading global supplier of hydrogen plants in the intermediate capacity range. We also signed an agreement to supply our smaller capacity H-3300 hydrogen purifiers to Nuvera Fuel Cells.

Products under development – Oil Refining: We are currently developing second generation ‘rapid cycle’ PSA technology which we believe will offer further reductions in size and cost relative to both our current commercial products and our competitors’ products. Our second generation products will also be scalable to much higher capacities than our current products, allowing us to compete in larger, higher value markets.

The first of these second generation products is the large capacity H-6200 PSA, which is being developed in collaboration with EMRE for use in a range of potential applications in the oil refining, petrochemical and gas processing industries.

Demand for hydrogen in oil refineries is expected to grow by up to 10% per year through to 2010, driven by regulations requiring reduced levels of sulphur in diesel fuel, increased processing of “heavier” crude feed stocks, and the global increase in demand for petroleum products. The H-6200 hydrogen purifier will provide refineries with a cost-effective solution to this growth in hydrogen demand by recovering hydrogen from hydrogen-containing waste streams within refineries. Based on the current project timeline, we expect to install and demonstrate a commercial-scale prototype of this product (“prototype plant”) at an ExxonMobil refinery in Europe in the first half of 2007.

In 2006 we signed a marketing agreement with EMRE that covers the marketing of the H-6200 hydrogen purifier to third-party customers in the oil refining industry. The agreement outlines the responsibilities of each party in the marketing process, and how the commercial gain from the sales of the product will be shared between QuestAir and EMRE.

We also are exploring the extension of the H-6200 platform technology into other high value markets including various petrochemical separations and the processing of contaminated natural gas.

Products under development – Fuel Cells: We currently market our commercial PSA products for use in hydrogen refueling stations that support fuel cell vehicles. To date we have sold 14 systems into demonstration hydrogen stations located in the US, Asia and Canada. Key customers in this emerging market include Chevron, Iwatani International and Hydrogenics Corporation.

We are also collaborating with EMRE on the development of an on-board hydrogen generator for potential use in a range of transportation markets including fuel cell powered utility equipment, auxiliary power units for a wide range of vehicles, and fuel cell powered buses. The hydrogen generator should offer a unique, compact, efficient solution to generate hydrogen directly on board the vehicle itself from a range of readily available hydrocarbon fuels such as diesel and gasoline.

Key Market Drivers

We believe that there are a number of key market drivers that will have an important impact on QuestAir’s long term prospects and our ability to create shareholder value:

- Increased global demand for refined petroleum products, combined with increased supplies of heavier ‘sour’ crude oil, which together have driven the demand for hydrogen in the oil refining industry.
- Government regulations mandating reduced sulphur levels in transportation fuels, which have also driven the demand for hydrogen in the oil refining industry to desulphurize crude oil feedstocks.
- Elevated prices of crude oil and natural gas, which has focused attention on technologies for increasing the efficiency of the refining processes, and for the processing of unexploited reserves of contaminated natural gas.
- Environmental concerns regarding local air pollution and global warming, which collectively have prompted the development of renewable energy sources such as biogas, as well as clean, efficient power generation and transportation technologies such as fuel cells.

Key Performance Indicators

Management uses a number of key performance indicators to monitor and assess the implementation of our strategy and the achievement of our goals. These performance indicators include both quantitative and qualitative measures of performance, as follows:

- **Sales Bookings and Backlog:** QuestAir recognizes revenue from the sale of gas purification systems and engineering service contracts. While revenue from the sale of engineering service contracts is recognized on a percentage-of-completion basis over the life of the contract, revenue from the sale of our commercial gas purification systems is only recognized once the systems have been installed, commissioned and accepted by the customer.¹ Given the typical lead times of 6-9 months between receipt of an order for a gas purification system and installation and commissioning, recognized revenues

¹ Refer to the ‘Critical Accounting Policies and Estimates’ section of the MD&A for an overview of QuestAir’s revenue recognition policy.

do not give a current view of our commercial performance. Consequently, we monitor sales bookings and changes in backlog as more current measures of our commercial performance. Sales bookings are defined as signed orders supported by a firm purchase order, while backlog represents the future revenue from signed orders that have not yet been recognized as revenue.

- *Cash Burn:* We believe that careful management of our cash consumption is critical in order to demonstrate a path to profitability and limit dilution arising from potential future equity financings. We monitor 'cash used in operations and capital requirements' as a measure of our operational cash burn. It should be noted that this is a non-GAAP measure, and a reconciliation to GAAP measures is provided in the 'Liquidity and Capital Resources' section of the MD&A.
- *Progress against key product development timelines and milestones:* The timing and technical progress of our key development programs, including the refinery program with EMRE, will have a critical impact on our future revenue growth and profitability. Consequently we closely monitor progress made in each development program relative to key program milestones and timelines. Several key program milestones are included in our corporate milestones which are set at the beginning of each fiscal year (see 'Outlook and Milestones for Fiscal 2007').
- *Patents & Intellectual Property:* QuestAir's competitive advantage is driven in large part by our technical leadership and strong intellectual property position. We monitor the breadth and quality of our patent portfolio relative to those of our competitors as an important measure of our technical competitive advantage.

Resources and Capabilities

We have the following resources and capabilities at our disposal in order to execute our growth strategy:

- *Non-Capital Resources:* A significant portion of our sustainable competitive advantage is derived from our proprietary PSA technology and strong suite of intellectual property. Our technology leadership and the value proposition of our products are driven directly by the innovation and technical expertise of our employees, and consequently, our human resources are our most critical non-capital resource.
- *Financial Resources:* At September 30, 2006, QuestAir had cash resources and short term investments totaling of \$18.4 million, and \$3.1 million remaining of a \$4 million credit facility. In addition, we have \$1.8 million of remaining funding available from Technology Partnerships Canada ("TPC"), a funding program of the Canadian Government. At forecast cash burn rates, we have sufficient financial resources to fund our operations for at least the next 24 months.
- *Systems and Processes:* We evaluate our management and control systems against evolving corporate governance regulations and guidelines. We follow a rigorous product

management process to manage our key development programs to ensure that all new products meet customer specifications, quality requirements and delivery timelines. In addition, we are ISO 9001:2000 registered and the relevant components of our commercial PSA products are certified to the standards of the Canadian Standards Association (CSA) and Underwriters Laboratory (UL), and conform to the legal requirements of the European Union (CE).

- *Partnerships with market leaders:* A key element of our strategy is to leverage the resources, technical expertise and distribution channels of our development partners and customers. We have established strong partnerships and working relationships with market leaders including EMRE, Shell Hydrogen, Chevron as well as our distribution and licensing partners Iwatani, Mitsubishi, KTI Technip, Hydro-Chem, HyRadix and Nuvera. We believe that these relationships are a source of competitive advantage for QuestAir.

BUSINESS OVERVIEW

We made the following key progress in our commercial and development activities during fiscal 2006:

- A number of key achievements were made in the program being undertaken with EMRE to develop the H-6200 hydrogen purifier for refinery and petrochemical applications. In April 2006 the program passed a critical internal ExxonMobil review, authorizing final funding to complete the construction and testing of a prototype H-6200 hydrogen purifier at an ExxonMobil refinery located in Europe. During fiscal 2006 we received purchase orders from ExxonMobil totaling \$4.3 million related to the prototype construction. A key purchase order was received in the fourth quarter of fiscal 2006, which extended the construction of the prototype plant into the fourth quarter of calendar 2006 (see 'Subsequent Events' section of the MD&A).
- We also signed a marketing agreement with EMRE which covers the marketing of the H-6200 hydrogen purifier to third-party customers in the oil refining industry. The agreement outlines the responsibilities of each party in the marketing process, and how the commercial gains from the sales of the product will be shared between QuestAir and EMRE. Following the signing of this agreement, we began jointly marketing and promoting the H-6200 with EMRE, and currently we are responding to a number of commercial enquiries from both ExxonMobil and third-party refineries.
- We completed an initial research contract with EMRE to assess the use of the H-6200 platform technology for the processing of contaminated or "sour" natural gas. This contract was significant in demonstrating the potential application of the product platform to other high-value markets outside of oil refining. Options for the next phase of this development work are currently being assessed.

- A number of breakthroughs were made in the sale of our commercial first generation gas purification products. During fiscal 2006, we sold our first M-3100 methane recovery system, valued at approximately US\$2 million, into the landfill gas processing market. The M-3100 system will recover pipeline-grade methane from landfill gas generated at the Rumpke Sanitary Landfill near Cincinnati, Ohio. This initial sale into the landfill gas market follows a successful demonstration of a M-3100 system at the Vancouver Landfill site which was undertaken during the year. In the industrial hydrogen market, we successfully started up two H-3100 hydrogen purifiers installed at the HydroEdge liquid hydrogen plant in Osaka, Japan. These are the largest capacity commercial hydrogen purifiers that we have operated to date, demonstrating the expansion of our commercial product line into the intermediate capacity range of the hydrogen plant market.
- Significant progress was made in expanding the distribution channels for our first generation products. We signed a manufacturing licensing agreement with Hydro-Chem LLC, a division of The Linde Group, and a leading manufacturer of hydrogen plants in the intermediate capacity range. Under the terms of the agreement, the H-3100 hydrogen purifier will be included in Hydro-Chem's industrial hydrogen plants, expanding our access to the intermediate capacity segment of the hydrogen plant market.
- We maintained our position as the leading supplier of hydrogen purification systems in the emerging hydrogen infrastructure market. During the year, we received orders for five H-3200 hydrogen purifiers for hydrogen fueling stations located in Canada, the United States and Korea. At year-end, we had sold 14 hydrogen purifiers into the hydrogen infrastructure market. We also signed an agreement, valued at up to US\$700,000 over 2 years, to supply our small capacity H-3300 hydrogen purifiers to Nuvera Fuel Cells. The H-3300 will be incorporated into Nuvera's PowerTap™ hydrogen generators, which will be marketed as a distributed source of hydrogen fuel to support fuel cell powered vehicles such as fork lifts and airport ground support vehicles.
- Early in the fiscal year, we received a \$1.4 million engineering services contract from EMRE to complete the second phase of a program to develop a compact on-board hydrogen generator for use in a range of transportation applications. Target markets for this product include potential early term fuel cell markets such as utility vehicles and auxiliary power units for heavy duty trucks and military vehicles.

The following progress was made towards the achievement of QuestAir's 2006 milestones:

Milestone	Progress
1. Pass final ExxonMobil program review and receive purchase orders for prototype large capacity hydrogen PSA.	The ExxonMobil program review was successfully passed in April 2006, authorizing final funding for the prototype construction and testing. QuestAir received purchase orders totaling \$4.3 million during fiscal 2006 towards the prototype plant construction.
2. Complete fabrication and shipment of the large capacity hydrogen PSA to ExxonMobil refinery.	The final purchase order for the prototype H-6200 was received in the fourth quarter of fiscal 2006, extending the completion of the prototype fabrication to around the end of calendar 2006, with shipment to follow shortly thereafter.
3. Sign agreement with EMRE for marketing of large capacity hydrogen PSA in the oil refining industry.	In May 2006 we signed an agreement with EMRE to jointly market the H-6200 hydrogen purifier to third-party customers in the oil refining market.
4. Sign agreement to extend large capacity PSA product platform into new market.	During fiscal 2006 we completed an initial contract with EMRE to assess the use of the H-6200 technology platform of the processing of sub-quality or "sour" natural gas. Options for further funded work in this area, or in other petrochemical markets are currently being assessed, with a formal agreement expected to follow in fiscal 2007.
5. Sign an additional distribution agreement for QuestAir's first generation gas purification products with a leading hydrogen plant vendor.	In March 2006 we signed a licensing agreement with Hydro-Chem, a leading global supplier of industrial hydrogen plants. QuestAir's H-3100 hydrogen purifier will be included as a standard offer in Hydro-Chem's product line.

FINANCIAL OVERVIEW

The financial highlights for the year ended September 30, 2006 are noted below:

- Revenue was \$7,558,093 for the year, increased by \$1,265,784, or 20% compared to fiscal 2005. Total revenues were in line with revenue guidance of at least \$7.5 million for the year.
- Sales order backlog at September 30, 2006 was \$5,043,892, increased by \$2,036,344, or 68%, from September 30, 2005.
- Cash used by operations and capital requirements was \$9,430,679 for the year, increased by \$736,050 compared to fiscal 2005. The cash burn was within the cash burn guidance range of \$8.5 million to \$9.5 million for the year.

- Net loss was \$10,262,918 (\$0.24 per share) for the year, increased \$746,060 or 8% from \$9,516,858 (\$0.31 per share) in fiscal 2005.

SELECTED FINANCIAL INFORMATION

The following is selected information on QuestAir's financial performance for the past three fiscal years:

	For the years ended September 30,		
(\$'000 except loss per share data)	2006	2005	2004
Revenue	7,558	6,292	3,002
Net research and development expenses	5,092	5,734	4,698
General and administrative expenses	3,311	3,427	2,479
Net loss	(10,263)	(9,517)	(9,516)
Loss per share	(0.24)	(0.31)	(1.94)
Total assets	27,682	16,213	12,564
Total long-term liabilities	533	434	121
Deficit	(95,045)	(84,783)	(73,561)
Total shareholders' equity	20,497	11,639	8,566
Cash used in operations and capital requirements	9,431	8,695	5,670
Backlog (unaudited)	5,044	3,008	3,918

QuestAir's revenues have increased over the past three years as a result of growth in the sales of gas purification systems, which have been driven by sales of our commercial PSA products, as well as revenue recognized towards the construction of the prototype H-6200 hydrogen purifier to be demonstrated at an ExxonMobil refinery. Revenues from engineering service contracts have also grown over the past three years, primarily as a result of new contracts received from EMRE for the development of the H-6200 hydrogen purifier, as well as the onboard hydrogen generator. The increase in revenue over this time period has been accompanied by a corresponding increase in sales order backlog, although there was a reduction in backlog during fiscal 2005, mainly due to a reduction in engineering service contracts booked during the year. Backlog increased during fiscal 2006 as a result of new purchase orders related to the prototype H-6200 hydrogen purifier and related equipment, as well as a M-3100 methane recovery system sold into the landfill gas processing market.

There has been some variability in research and development ("R&D") expenditures over the past three years as a result of changes in the focus and activity level of our R&D program over this period. The increase in R&D expenditures in fiscal 2005 was a result of increased activity in the development program undertaken with EMRE to develop a large capacity PSA for use in oil refineries. The subsequent decrease in R&D in fiscal 2006 relates to the transition of those resources from development activities to construction of the prototype H-6200 hydrogen purifier being sold to ExxonMobil as discussed in 'Results of Operations' below.

General and Administrative ("G&A") expenses have also fluctuated over the past three years. G&A expenses were elevated in fiscal 2005 as a result of increased expenses

related to QuestAir's public listing. The decrease in G&A expenses in fiscal 2006 includes reductions in stock-based compensation expenses, as certain options became fully vested during the period (see 'Results of Operations').

Total assets have increased over the past three years, and include funds raised from QuestAir's initial public offering ("IPO") in fiscal 2005 and the subsequent equity offering in fiscal 2006 as discussed in 'Use of Proceeds from our Public Offerings'.

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:

(\$ '000)	For the years ended September 30,	
	2006	2005
Gas purification systems	5,808	4,158
Engineering service contracts	1,750	2,134
Total revenue	7,558	6,292

The total recognized revenue of \$7,558,093 for fiscal 2006 was in line with revenue guidance of at least \$7,500,000 provided by management in the fiscal 2005 MD&A dated December 8, 2005. The increase in revenue from gas purification systems for fiscal 2006 resulted from increased sales of commercial PSA systems including the H-3100 hydrogen purifier commissioned at the HydroEdge liquid hydrogen plant in Japan, as well as revenue recognized towards the construction of the prototype H-6200 hydrogen purifier to be demonstrated at an ExxonMobil refinery. For accounting purposes, the sale of the H-6200 prototype plant is treated as a long-term production-type contract. Consequently, in accordance with GAAP, revenue from the H-6200 prototype plant is recognized on a percentage-of-completion basis.

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

Fluctuations in recognized revenue and the receipt of new sales orders are to be expected in the industrial markets that we currently serve. In addition, the timing of receipt of new engineering service contracts can vary from year to year. As mentioned in the 'Key Performance Indicators' section, we believe that both 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 years ended September 30, 2006 and 2005.

(Unaudited, \$ '000)	For the year ended September 30, 2006			For the year ended September 30, 2005		
	Gas Purification Systems	Engineering Service Contracts	Total	Gas Purification Systems	Engineering Service Contracts	Total
Opening Balance	2,240	768	3,008	2,812	1,106	3,918
Bookings	8,642	1,226	9,868	3,897	1,951	5,848
Revenue Recognized	(5,808)	(1,750)	(7,558)	(4,158)	(2,134)	(6,292)
Adjustments ²	(166)	(108)	(274)	(311)	(155)	(466)
Ending Balance	4,908	136	5,044	2,240	768	3,008

The total sales order backlog increased by \$2,036,344, or 68%, during fiscal 2006. The increase in backlog over the fiscal year was driven by orders valued at \$4,312,553 related to the prototype H-6200 hydrogen purifier and associated equipment. In addition, we also received an order valued at approximately \$2,200,000 for an M-3100 methane recovery system for use in the landfill gas processing market. A negative adjustment was made to sales order backlog as a result of foreign exchange fluctuations during the year.

We currently expect that the backlog as of September 30, 2006 will be substantially recognized as revenue by March 31, 2007.

Gross Profit

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

(\$ '000)	For the years ended September 30,	
	2006	2005
Sales	7,558	6,292
Cost of goods sold	6,433	3,537
Gross Profit	1,125	2,755
Gross Margin (%)	14.9%	43.8%

The decrease in gross margin for fiscal 2006 compared to the prior year resulted from a decrease in the proportion of revenue recognized from engineering service contracts, which typically contribute high gross margins. In addition, losses were incurred on the H-3100 hydrogen purifier installed at the HydroEdge liquid hydrogen plant, and on the prototype H-6200 hydrogen purifier. Low margins were expected on the HydroEdge plant since this was the first sale of the new larger capacity H-3100 design for use in the intermediate capacity segment of the hydrogen plant market, and certain non-recurring engineering costs were incurred to increase the capacity of the H-3100 product design. Ultimately, a loss was recognized on the sale due to unfavorable exchange rate fluctuations which reduced recognized revenue, and higher than expected start-up costs.

EMRE and QuestAir had agreed that the prototype H-6200 would be sold to an ExxonMobil refinery at cost, reflecting the fact that the prototype H-6200 is intended, in part, for testing and demonstration purposes. Additional functionality and test instrumentation were subsequently included in the plant

design to allow for additional testing under a wider range of conditions than is required for the European refinery itself. We agreed to share these specific additional costs with EMRE to reflect the shared future benefit that will be derived from the additional test data. The additional costs associated with enhanced functionality and test instrumentation resulted in an expected net loss on the overall prototype plant. In accordance with GAAP, we recorded the total expected loss on the H-6200 prototype as a cost of goods sold in fiscal 2006.

It should be noted that both the HydroEdge and H-6200 prototype systems were the first of their kind manufactured by QuestAir, and we made a strategic investment in these units for market development purposes. As such, the losses on these two sales do not reflect the expected future margins for the H-3100 or H-6200 product lines.

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

Sales and Marketing

Sales and marketing expenses were \$1,938,537 for fiscal 2006, an increase of 9% compared to \$1,779,703 for the prior year. The increase in sales and marketing expenses for fiscal 2006 was attributed to an increased level of sales activities compared to the prior year.

Research and Development

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

(\$ '000)	For the years ended September 30,	
	2006	2005
Gross R&D Expenditure	6,907	7,667
Government & Partner Funding	1,815	1,933
Net R&D Expenditure	5,092	5,734

The 10% reduction in gross R&D expenditures for fiscal 2006 compared to the prior year was due to a reduction in the amount of R&D undertaken as resources were redirected towards supporting our commercial sales efforts and the construction of the prototype H-6200 hydrogen purifier. Government funding decreased for the year in proportion to the reduction in R&D undertaken on the refinery development program with EMRE, which is eligible for funding from TPC.

² Includes adjustments for fluctuations in foreign currency exchange rates as well as cancelled orders.

General and Administrative

G&A expenses were \$3,311,188 for fiscal 2006, a decrease of 3% from \$3,427,315 for the prior year. The decrease in G&A expenses for the year related to a reduction in stock-based compensation expenses in the year, partially offset by increases in accounting and regulatory expenses.

Stock-based compensation expense was \$492,302 for fiscal 2006, a decrease of 35% from \$754,759 for the prior year. Stock-based compensation expenses were higher for the prior year due to a stock compensation charge related to the repricing of certain options at the time of our IPO in fiscal 2005.

Amortization

Amortization expenses were \$1,223,788 for fiscal 2006 compared to \$1,531,112 for the prior year. The decrease in amortization expenses was a result of certain capital assets becoming fully amortized during the year.

Other Income

Other income was \$177,630 for fiscal 2006 compared to \$199,877 in the prior year. The reduction in other income resulted from an increase in foreign exchange losses, offset partially by increased interest income earned from funds raised in an equity offering in May 2006 (see Liquidity and Capital Resources).

Net Loss

Net loss for fiscal 2006 was \$10,262,918 (\$0.24 per share) compared to \$9,516,858 (\$0.31 per share) for the prior year. The increase in the net loss for the year was primarily a result of reduced gross profits compared to the prior year, partially offset by lower R&D and amortization expenses.

Loss per share is calculated based on the weighted average number of common shares outstanding through the

year. The reduction in the loss per share for the year was a result of an increase in the weighted average number of common shares outstanding compared to the prior year (refer to 'Outstanding Share Data').

Capital Expenditures

Capital expenditures net of Government funding and proceeds on sale ("Net CAPEX"), for fiscal 2006 were \$1,370,315 compared to \$915,424 for the prior year. The increased Net CAPEX for the year was driven by leasehold improvements made to new hydrogen testing facilities that were built during fiscal 2006, as well as expenditures on a demonstration landfill gas processing plant installed at the Vancouver Landfill.

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

Use of Proceeds from our Public Offerings

We disclosed our expectations regarding the use of the net proceeds of our IPO in our prospectus dated December 14, 2004. In addition, we disclosed our expectations regarding the use of the net proceeds of our subsequent equity offering in our prospectus dated May 23, 2006. Net cash proceeds from the IPO were \$11,694,571, while net cash proceeds from the equity offering were \$18,410,751. As at September 30, 2006, we had used \$10,430,168 of this amount to fund our operating activities. The balance of the IPO funds and the entire funds from the equity offering remain available for the uses described in the prospectuses, and we intend to use these funds as described in the prospectuses. Circumstances may arise, however, which may result in a reallocation of funds for sound business reasons.

The table below compares the estimated use of proceeds disclosed in our IPO prospectus to the actual results as at September 30, 2006.

Use of proceeds noted in Prospectus	Prospectus Comment	Actual Use to September 30, 2006
Sales and Marketing: Approximately 20%	To drive sales growth and expand the Company's market channels	21%
Research and Development: Approximately 40%	To develop and commercialize products for the Company's industrial hydrogen and fuel cell related markets	56%
Capital Expenditures: Approximately 30%		15%
Working capital, general corporate purposes and selective acquisitions or investments: Approximately 10%	In conjunction with funds from operations, used for new products, technologies and businesses that expand, complement or are otherwise related to the Company's existing business.	8%

The proportion of spending on R&D was higher than expected as a result of increased research activities related to the refinery program with ExxonMobil. This increase was offset by lower-than-expected spending on capital assets.

SUMMARY OF QUARTERLY RESULTS

(Unaudited, \$ '000
except loss per share data)

	2006			2005			2004	
	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31
Total Revenues	2,697	1,193	2,796	872	1,159	2,644	1,491	998
Gas Purification Systems	2,530	574	2,483	221	373	2,307	480	998
Eng. Service Contracts	167	619	313	651	786	337	1,011	0
% Gross Margin	3%	40%	(7%)	87%	45%	27%	78%	35%
R&D (net)	1,330	1,236	1,253	1,273	1,436	1,491	1,533	1,274
General & Administrative	835	776	902	798	917	941	773	796
Net Loss	2,724	2,135	3,336	2,068	2,588	2,562	1,843	2,523
Net Loss per share	(0.05)	(0.05)	(0.09)	(0.06)	(0.06)	(0.07)	(0.05)	(0.29)
Net CAPEX	615	354	70	331	19	575	292	30
Cash used in Operations & Net CAPEX	3,508	1,876	1,724	2,322	2,295	1,673	2,732	1,994
Backlog	5,044	4,976	5,840	5,702	3,008	3,471	5,356	5,500
Gas Purification Systems	4,908	4,570	4,815	4,359	2,240	1,848	3,623	4,102
Eng. Service Contracts	136	406	1,025	1,343	768	1,623	1,733	1,398

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 a customer order, and on contractual terms related to the timing of delivery and acceptance of products and services by customers. As a result, percentage gross margins have fluctuated significantly from quarter to quarter. In general, gross margins on engineering service contracts are higher than those on gas purification systems, resulting in increased gross margins for quarters with a high proportion of recognized revenue from engineering service contracts.

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

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

Review of the Fourth Quarter, Ended September 30, 2006

Total revenues for the quarter ended September 30, 2006, were \$2,696,596, increased by 133% from \$1,158,898 for the same period in 2005. The increase in revenues was mostly related to revenue recognized on a percentage-of-completion basis towards the construction of the prototype H-6200 hydrogen purifier during the quarter. Sales order backlog was \$5,043,892 at September 30, 2006, increased 1% from \$4,976,342 at June 30, 2006. Cash used in operations and capital expenditures for the quarter ended September 30, 2006 was \$3,508,457, increased by 53% from \$2,296,158 in the same period in 2005. Cash used in operations increased by \$929,545 from the same period in 2005, driven by increases in accounts receivable and inventory primarily

related to the prototype H-6200 hydrogen purifier. Net CAPEX increased by \$282,754 from the same period in 2005, driven by leasehold improvements for new hydrogen testing facilities that were completed during the fourth quarter of fiscal 2006. The net loss for the quarter ended September 30, 2006 was \$2,724,580, increased 5% from \$2,587,801 in the same period in 2005.

CASH FLOWS, LIQUIDITY AND CAPITAL RESOURCES

Cash Flows

Cash and cash equivalents were \$11,018,800 at September 30, 2006, increased by \$706,977 from \$10,311,823 at September 30, 2005. This increase in cash and cash equivalents during the year was driven by cash inflows from financing activities and changes in working capital of \$18,691,614 and \$159,695 respectively, partially offset by net operating losses for the year (excluding changes in working capital) of \$8,537,706 and cash outflows from investing activities of \$9,606,626.

Cash used by operations for the year ended September 30, 2006 was \$8,378,011, compared to \$7,779,205 for the prior year. The increase in cash used by operations for the year was driven by an increased loss for the year, as well as an increase in inventory. This was partially offset by increases in accounts payable, accrued liabilities and deferred revenue, as well as decreases in amortization and stock-based compensation.

Cash used in investing activities for the year ended September 30, 2006 was \$9,606,626, compared to \$1,017,820 for the prior year. The increase in cash used in investing activities for the year primarily related to a \$7,400,000 increase in short-term investments with maturity dates greater than ninety days from the date of purchase. No such investments were made in the prior year. The increase in cash used in investing activities was also attributed to an increase in restricted cash set aside to fund remaining equipment purchases for the H-6200 prototype plant in fiscal 2007.

Net cash flow from financing activities was \$18,691,614 for the year ended September 30, 2006, compared to \$12,416,925 for the prior year. The cash inflow in the year resulted primarily from net cash proceeds raised from our common share offering which closed on May 31, 2006. The cash inflow from financing activities for the prior year resulted primarily from net cash proceeds raised from our IPO in December 2004.

As noted in the 'Key Performance Indicators' section, 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 year ended September 30, 2006 was \$9,430,679, compared to \$8,694,629 for the prior year. Cash burn for the year fell within the guidance range of \$8,500,000 to \$9,500,000 provided by management on December 8, 2005. 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:

(\$ '000)	For the years ended September 30,	
	2006	2005
Cash used in Operating Activities	(8,378)	(7,779)
Add: purchase of property, plant and equipment ("PP&E")	(1,155)	(1,262)
Add: government grants and funding related to PP&E	96	335
Add: proceeds from sale of PP&E	6	11
Cash used in Operations and Capital Requirements	(9,431)	(8,695)
Reconciliation to GAAP Statements of Cash Flow:		
Add: Short-term investments	(7,400)	-
Add: restricted cash	(1,154)	(102)
Add: Cash from Financing Activities	18,692	12,417
Increase in Cash and Cash Equivalents	707	3,620

The increase in cash burn for the year ended September 30, 2006 compared to the prior year resulted from increased operational losses as well as increased net capital expenditures.

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 September 30, 2006 cash and short-term investments were \$18,418,800, compared to \$10,311,823 at September 30, 2005. Not included in cash and short term investments at September 30, 2006 was \$1,256,354 of restricted cash, which will primarily be used to fund remaining equipment purchases for the H-6200 prototype plant in fiscal 2007.

On May 31, 2006, we completed an equity offering, raising gross proceeds of \$20,000,250 through the sale of 14,815,000 common shares at a price of \$1.35 per share. Net proceeds after share issuance costs were \$18,410,751.

We expect to use our current cash resources to complete the development and commercialization of our products currently under development, as well as new products

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

Credit Facilities

During fiscal 2005, we signed a credit facilities agreement with Comerica Bank. This agreement was amended and restated as part of the renewal of these facilities in June 2006. The amended credit facilities include a US\$1 million accounts receivable line of credit and a US\$2 million term loan, in addition to \$673,212 outstanding under the original term loan agreement. Both facilities are subject to annual renewal. As at September 30, 2006, we had drawn \$884,250 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 September 30, 2006. We expect to fund these expenditures out of our cash reserves:

	(Unaudited, \$ '000)		Payments due by Period		
	Total	In the next year	2-3 years	4-5 years	After 5 years
Bank debt	884	351	533	-	-
Capital leases	-	-	-	-	-
Operating leases	1258	509	605	144	-
Purchase obligations ³	4,532	4,532	-	-	-
Total contractual obligations	6,674	5,392	1,138	144	-

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. As at September 30, 2006, funding contributions remain available under only the first listed program noted below. If that program were to be terminated early, we would receive less research funding and our net R&D costs would be higher than we expect.

Technology Partnerships Canada

On June 6, 2003, we were awarded a \$9,600,000 conditionally repayable loan from TPC, a funding program administered by Industry Canada. At September 30, 2006,

³ Purchase obligation is defined as an agreement to purchase goods or services that is enforceable or legally binding on the Company that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.

we had claimed \$7,760,083 against this loan. These funds are repayable under certain conditions. Based on forecasted R&D expenditures, we expect to draw down on the remaining \$1,839,917 of TPC funding by the end of fiscal 2007, at which time the contribution phase of this program ends.

We entered into a similar funding arrangement with TPC on March 31, 1999 and received a total of \$4,762,503 in funding from March 1999 to July 2002. The funding is also repayable only under certain conditions. The repayment obligations and total royalty repayments made to date for these funding programs are listed below:

Funding Award Date	Description	Royalties	Term	Royalty Payments to Date
June 6, 2003	Fast Cycle Pressure Swing Adsorption & Gas Management Systems Program	Annual royalties of 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 \$23.6 million. If the royalties are less than \$23.6 million by September 30, 2013, the royalty period will continue until the earlier of September 30, 2021 or until a cumulative royalty ceiling of \$23.6 million is reached.	Accrued for future payment: \$146,800
March 31, 1999	Pulsar Pressure Swing Adsorption Program	Annual royalties of 1.8% of gross project revenues and fuel cell related products	Royalty period extends to the later of the date of payment of all amounts due to the Minister and 2015. The maximum cumulative repayment is \$8.75 million	Payments: FY05: \$10,698 FY06: \$6,960 Total Cumulative payments: \$32,952 Accrued for future payment: \$13,273

Department of Natural Resources Efficiency and Alternative Energy Program

On January 4, 2005, we were awarded a grant for \$225,000 from the Government of Canada under the Department of Natural Resources Efficiency and Alternative Energy

Program. On January 6, 2004, we received a similar funding award of \$193,944 under the same funding program. Both funding awards are repayable under certain conditions. The repayment obligations and total royalty repayments made to date for these funding programs are listed below:

Funding Award Date	Description	Royalties	Term	Royalty Payments to Date
January 4, 2005	Development of structured adsorbent for the production of high purity hydrogen	Annual royalties of 0.12% of gross project revenues	Royalty period starts on date of first gross project revenues and extends to March 31, 2015, to a maximum cumulative repayment of \$225,000, whichever occurs first.	Payments: \$0 Accrued for future payment: \$0
January 6, 2004	Development of a device that increases the efficiency of a High Temperature fuel Cell system	Annual royalties of 0.12% of gross project revenues	Royalty period starts on date of first gross project revenues and extends to March 31, 2014, to a maximum cumulative repayment of \$193,944, whichever occurs first.	Payments: \$0 Accrued for future payment: \$0

OUTSTANDING SHARE DATA

Common Shares Outstanding

Immediately prior to closing the IPO on December 21, 2004, we completed a reorganization of our share capital whereby the existing share classes were converted into a single class of common shares. To complete the share capital reorganization, certain terms of the preferred shares relating to automatic conversion rights were amended (refer to note 9(b) to the audited consolidated financial statements for fiscal 2006 for further details). On May 31, 2006 we completed an offering of common shares, issuing 14,815,000 common shares from treasury. As a result of the share capital reorganization and the issuance of shares upon the IPO and subsequent equity offering, our authorized share capital consists of an unlimited number of common shares, of which 52,393,065 common shares were issued and outstanding as of November 30, 2006. We also have an unlimited number of preferred shares authorized, none of which are issued.

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

	For the years ended September 30,	
	2006	2005
Weighted Average Common Shares Outstanding	42,426,280	30,017,856

The average number of common shares outstanding increased for the year ended September 30, 2006, compared to the prior year as a result of the issuance of 14,815,000 new common shares upon the closing of our equity offering on May 31, 2006.

Stock Options and Warrants Outstanding

As at November 30, 2006 there were 4,910,625 stock options and 192,308 share purchase warrants outstanding which collectively could result in the issuance of 5,102,933 common shares if such options and warrants are exercised by the holders in accordance with the terms thereof.

RELATED PARTY TRANSACTIONS

QuestAir had a consulting agreement with Dr. Denis Connor, Chairman of the Company, for consulting services related to our government relations activities. Under this agreement, Dr. Connor received \$18,000 in fees during the quarter ended December 31, 2005, at which time the contract terminated.

SUBSEQUENT EVENTS

Subsequent to the end of fiscal 2006, there were a number of developments in our refinery program with EMRE. In October 2006 we renewed our Joint Development Agreement ("JDA") with EMRE, extending the exclusivity period of our research collaboration in the refinery and petrochemical market with EMRE for a further 3 years. The extension of the JDA is intended to allow us to complete additional product development work with EMRE to extend the H-6200 product platform into additional markets in the oil refining and petrochemical markets.

During the first quarter of fiscal 2007, we experienced further delays in the fabrication of the prototype H-6200 hydrogen purifier to be demonstrated at the ExxonMobil refinery in Europe. These delays were principally related to the heavy construction activity in the oil and gas sector in North America, which created capacity constraints at one of our key suppliers that is assembling the prototype plant skid. Consequently, we now expect to complete the fabrication of the prototype plant around the end of calendar 2006, and to ship the prototype to Exxon's refinery early in the first quarter of calendar 2007. The prototype plant will be installed and started up at the refinery site during the first half of calendar 2007.

OUTLOOK

Demand for hydrogen in the refining of crude oil is forecast to grow by between 8-10% per annum through 2010. In addition, hydrogen consumption per barrel of oil is forecast to grow from approximately 400 cubic feet per barrel ("cf/bbl") to approximately 800 cf/bbl by 2010, driven by increasingly stringent regulations for sulphur content in transportation fuels, and increased processing of heavier, sour crude oil stocks.

We believe that these macroeconomic drivers in the oil refining industry will create a compelling growth opportunity for our H-6200 hydrogen purifier currently under development. By focusing on the aggressive penetration of the oil refining market with the H-6200 product, as well as by extending this technology platform into additional energy-related markets such as natural gas processing and petrochemical separations, we believe that very significant growth in revenue will be achieved over the next several years.

Fiscal 2007 will be a landmark year for QuestAir with the commercialization of our H-6200 hydrogen purifier in the oil refining market. Key objectives for the coming year include the installation and start up of the prototype H-6200 hydrogen purifier at an ExxonMobil refinery, and the subsequent first sale of a fully commercial H-6200 system in the oil refining market. We also expect to see continued growth in the sale of our first generation gas purifiers in the industrial hydrogen and biogas markets.

QuestAir's operational and financial milestones for the remainder of fiscal 2007 are:

1. *Complete the installation and startup of the prototype H-6200 hydrogen purifier at an ExxonMobil refinery.* We expect that the prototype H-6200 hydrogen purifier will be installed and started up at the ExxonMobil refinery during the first half of calendar 2007.
2. *Receive the first purchase order for a commercial H-6200 hydrogen purifier.* EMRE and QuestAir are actively marketing the H-6200 to both ExxonMobil and third-party refineries, with the objective of securing a purchase order for the first commercial sale during fiscal 2007.
3. *Sign an agreement to extend the H-6200 platform into a new market.* QuestAir has entered into a number of preliminary engineering contracts to assess the application

of the H-6200 platform technology into additional markets such as natural gas processing and other separations in the petrochemical industry. Based on the outcome of these preliminary studies, we aim to sign an agreement to undertake the next phase of this product development.

4. *Secure first purchase order for a methane purification system in the European biogas market.* There is significant interest in Europe in the use of renewable sources of methane to supplement imported natural gas, and as a carbon neutral source of transportation fuel for busses and cars. During the year, we expect to sell our first system in the European market to recover high purity methane from biogas.
5. *Increase recognized revenue to between \$9 and \$10 million.* Total recognized revenue is expected to be between \$9 and \$10 million in fiscal 2007, representing an increase of approximately 19% to 32% from \$7.6 million in fiscal 2006. We expect revenue growth from both our first generation commercial products and anticipated engineering service contracts. Any commercial H-6200 orders received during fiscal 2007 are not expected to be recognized as revenue during fiscal 2007 given the expected manufacturing and installation time of these large units.
6. *Manage cash used in operations and capital expenditures to between \$7 and \$8 million.* Cash used in operations and capital expenditures is expected to be in the range of \$7 to \$8 million, reduced from \$9.4 million in fiscal 2006. Expenditures on both the commercialization of the H-6200 product, as well R&D activities related to the extension of the H-6200 platform technology into new markets are expected to continue through fiscal 2007.

It should be noted that we have made certain assumptions regarding the receipt of new engineering service contracts and gas purification sales in determining our revenue and operational cash burn milestones for fiscal 2007. Failure to secure certain of these contracts may have a material impact on our recognized revenue and cash burn for fiscal 2007, and we will update our financial guidance accordingly if our financial outlook is impacted in this way.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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 years ended September 30, 2006 and 2005 there were no material adjustments to long-term production-type contract and engineering service contract revenue relating to revenue recognized in a prior period.

Stock-based compensation

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

Inventory

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

The majority of our inventory is purchased directly to work in process when a customer order is received, and only a small portion is held in raw materials. This reduces the exposure to provisions for obsolescence. For the year ended September 30, 2006, raw materials on hand of \$502,472 includes \$55,645 of spare parts inventory available for sale to customers for use on commercial units in the field.

Warranty Provision

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

CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION

The CICA released new standards related to financial instruments in April 2005: Section 3855, *Financial Instruments – Recognition and Measurement*; Section 3865, *Hedges*; Section 1530, *Comprehensive Income*; Section 3861, *Financial Instruments – Disclosure and Presentation*; and Section 3251, *Equity*. These sections specify when a financial instrument or non-financial derivative is to be recognized on the balance sheet. These sections will 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 to be recognized and presented, including introducing comprehensive income; specify how hedge accounting should be 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 will 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 will be recognized as either assets or liabilities on the balance sheet at fair value. All gains and losses (realized or unrealized) from such derivatives will be recognized in the income statement in the period in which they occur.

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

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

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

DISCLOSURE CONTROLS AND PROCEDURES

The Company maintains a set of disclosure controls and procedures designed to ensure that information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in provincial securities legislation. The Company evaluated its disclosure controls and procedures as defined under Multilateral Instrument 52-109 for the year ended September 30, 2006. This evaluation was performed by the Chief Executive Officer and the Chief Financial Officer with the assistance of other Company employees to the extent necessary and appropriate. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective.

INTERNAL CONTROLS AND PROCEDURES

The Company maintains a set of internal controls over financial reporting which have been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP. The Company evaluated the design of its internal controls and procedures as defined under Multilateral Instrument 52-109 for the year ended September 30, 2006. This evaluation was performed by the Chief Executive Officer and the Chief Financial Officer with the assistance of other Company employees to the extent necessary and appropriate. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design of these internal controls and procedures was effective.

There were no changes in the Company's internal control over financial reporting that occurred during the fourth fiscal quarter that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

RISKS & UNCERTAINTIES

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

Technology and Competitive Risks

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

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

Market Risks

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

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

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

Regulatory Risk

Demand for our refinery related products is also driven in part by regulations mandating the reduction of sulphur levels in transportation fuels such as gasoline and diesel. In addition the expected demand for fuel cell technologies in the transportation sector is driven in part by local air pollution regulations and regulatory pressures to reduce

greenhouse gas emissions. It is clear that a significant roll-back in any of these regulations could materially impact our growth prospects. Our strategy of diversifying our market opportunities into multiple markets is intended to minimize our exposure to regulatory risk in specific markets.

Partner Risk

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

Financial Risk

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

Key Personnel Risk

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

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying financial statements of QuestAir Technologies Inc. and all the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgements. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. Management has prepared the financial information presented elsewhere in the Annual Report and has ensured that it is consistent with that in the financial statements. QuestAir Technologies Inc. endeavours to maintain systems of internal accounting and administrative controls of high quality, consistent with reasonable cost. Such systems are necessary to provide reasonable assurance that the financial information is relevant, reliable and accurate and that the Company's assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee. The Audit Committee meets periodically with management, as well as the external auditors, to discuss internal controls over

the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is properly discharging its responsibilities, and to review the Annual Report, the financial statements and the external auditors' report. The Committee reports its findings to the Board for consideration when approving the financial statements for issuance to the shareholders. The Committee also considers, for review by the Board and approval by the shareholders, the engagement or re-appointment of external auditors.

The Company's financial statements have been audited by PricewaterhouseCoopers LLP, the external auditors, in accordance with generally accepted auditing standards on behalf of the shareholders. PricewaterhouseCoopers LLP have full and free access to the Audit Committee.



Jonathan Wilkinson
President & Chief Executive Officer



Sherry Tryssenaar
Vice President Finance and Administration &
Chief Financial Officer

AUDITORS' REPORT

To the Shareholders of QuestAir Technologies Inc.

We have audited the consolidated balance sheets of **QuestAir Technologies Inc.** as at September 30, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant

estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants
Vancouver, British Columbia
December 5, 2006

CONSOLIDATED BALANCE SHEETS

As at September 30, 2006 and 2005

(expressed in Canadian dollars)	2006 \$	2005 \$
ASSETS		
Current assets		
Cash and cash equivalents	11,018,800	10,311,823
Restricted cash (note 3)	1,256,354	102,396
Short-term investments	7,400,000	-
Accounts receivable	1,476,024	1,075,255
Grants and funding receivables	454,597	493,913
Inventories (note 4)	3,510,508	1,945,876
Prepaid expenses	337,335	299,757
	25,453,618	14,229,020
Property, plant and equipment (note 5)	2,103,626	1,984,014
Other long-term assets	125,000	-
	27,682,244	16,213,034
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities (note 6)	4,413,717	2,210,686
Deferred revenue	1,946,781	1,602,103
Current portion of bank debt (note 7)	351,398	216,839
Obligations under capital lease (note 8)	-	110,357
	6,711,896	4,139,985
Bank debt (note 7)	532,852	433,678
	7,244,748	4,573,663
SHAREHOLDERS' EQUITY		
Share capital (note 9)		
Authorized		
Unlimited common shares, voting, no par value		
Unlimited preferred shares, issuable in series, no par value		
Common shares	109,020,202	89,774,802
Contributed surplus (note 9)	6,462,772	6,647,129
Deficit	(95,045,478)	(84,782,560)
	20,437,496	11,639,371
	27,682,244	16,213,034

Nature of operations and going concern (note 1)

Commitments and contingencies (note 12)

Approved by the Board of Directors



Director



Director

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the years ended September 30, 2006 and 2005

(expressed in Canadian dollars)	2006 \$	2005 \$
Revenue	7,558,093	6,292,309
Cost of goods sold	6,432,954	3,537,068
Gross profit	1,125,139	2,755,241
Operating expenses		
Research and development - net (note 10)	5,092,174	5,733,846
General and administration	3,311,188	3,427,315
Sales and marketing	1,938,537	1,779,703
Amortization	1,223,788	1,531,112
	11,565,687	12,471,976
Loss before undernoted	(10,440,548)	(9,716,735)
Other income (expense)		
Interest income	378,872	226,165
Other expense	(201,242)	(26,288)
	177,630	199,877
Loss for the year	(10,262,918)	(9,516,858)
Deficit - Beginning of year	(84,782,560)	(73,560,609)
Preferred share conversion (note 9)	-	(1,705,093)
Deficit - End of year	(95,045,478)	(84,782,560)
Basic and diluted loss per share (notes 9 and 14)	(0.24)	(0.31)

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended September 30, 2006 and 2005

(expressed in Canadian dollars)	2006 \$	2005 \$
Cash flows from operating activities		
Loss for the year	(10,262,918)	(9,516,858)
Items not involving cash		
Amortization	1,223,788	1,531,112
Gain on sale of property, plant and equipment	8,619	(7,418)
Stock-based compensation	492,302	754,759
Foreign currency gain (loss)	503	(9,661)
	(8,537,706)	(7,248,066)
Changes in non-cash operating working capital		
Accounts, grants and funding receivables	(361,454)	(455,846)
Inventories	(1,546,335)	(269,864)
Prepaid expenses	(162,579)	(209,474)
Accounts payable and accrued liabilities	1,885,385	782,382
Deferred revenue	344,678	(378,337)
	159,695	(531,139)
	(8,378,011)	(7,779,205)
Cash flows from investing activities		
Increase in short-term investments	(7,400,000)	-
Purchase of property, plant and equipment	(1,155,334)	(1,261,919)
Government grants and funding related to property, plant and equipment	96,791	335,600
Proceeds on sale of property, plant and equipment	5,875	10,895
Increase in restricted cash	(1,153,958)	(102,396)
	(9,606,626)	(1,017,820)
Cash flows from financing activities		
Issuance of common shares	20,000,250	15,050,000
Share issue costs	(1,589,499)	(2,835,287)
Issuance of common shares on exercise of stock options	157,991	20,470
Repayment of obligations under capital lease	(110,860)	(115,568)
Repayment of bank debt	(197,749)	-
Term loan advance	431,481	650,518
Deferred charges	-	(353,208)
	18,691,614	12,416,925
Increase in cash and cash equivalents	706,977	3,619,900
Cash and cash equivalents - Beginning of year	10,311,823	6,691,923
Cash and cash equivalents - End of year	11,018,800	10,311,823

Supplemental cash flow information (note 15)

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006 and 2005

1 NATURE OF OPERATIONS AND GOING CONCERN

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 that will provide hydrogen fuel for fuel cell powered vehicles.

While the accompanying consolidated 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 September 30, 2006, has an accumulated deficit of \$95,045,478. The Company's ability to continue as a going concern will depend 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 consolidated 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 consolidated financial statements, then adjustments would be necessary in the carrying value of assets and liabilities, the reported net losses, and the balance sheet classifications used.

2 SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. On November 29, 2004, the Company dissolved its inactive, wholly owned subsidiary, QuestAir Technologies (USA) Inc.

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities 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.

Cash and cash equivalents

Cash and cash equivalents consist of cash on deposit and highly liquid short-term interest bearing securities with maturities at the date of purchase of three months or less.

Short-term investments

Short-term investments consist of interest bearing securities with original terms to maturity of less than one year and are carried at cost, which approximates fair value. The Company has the intention and the ability to hold these securities to maturity. Interest earned and market value losses are recognized immediately in the consolidated statement of operations and deficit.

Inventories

Inventories are recorded at the lower of cost and replacement cost for raw materials and supplies and at the lower of cost and net realizable value for work-in-progress and finished goods. Costs of raw materials are determined on an average cost basis. Work-in-progress and finished goods include materials, direct labour and production overhead. Inventories are recorded net of any obsolescence provision.

Property, plant and equipment

Property, plant and equipment are recorded at cost (net of third-party funding) less accumulated amortization. Amortization is computed using the straight-line method over an asset's estimated useful life at the following rates:

Test equipment	20%
Computer equipment	30%
Leasehold improvements	lease term
Lab and warehouse equipment	20%
Manufacturing equipment	33%
Office equipment	20%
Furniture and fixtures	20%

Impairment of long-lived assets

Long-lived assets are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The Company tests the recoverability of long-lived assets based on future undiscounted cash flows expected to result from the use of the related assets. An impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

Revenue recognition

The Company recognizes revenue on commercial equipment sales when title has transferred, the customer has accepted the product, there is persuasive evidence of an arrangement, collection is probable and the price is fixed or determinable. Provisions are established for estimated product returns and warranty costs at the time revenue is recognized. The Company records deferred revenue when cash is received in advance of all of these revenue recognition criteria being met.

Revenues 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. Costs and estimated profit on contracts in progress in excess of amounts billed are reflected as work-

in-progress. Cash received in advance of revenues being recognized on contracts is classified as deferred revenue.

The Company monitors its contracts with customers on a regular basis to determine if a loss is likely to occur. If a loss is anticipated on a contract, the entire estimated loss is recorded as a cost of sales and a reduction in work-in-progress in the period in which the loss becomes evident and reasonably estimable.

Warranty costs

The Company provides for future warranty costs on products sold based on management's best estimates of such costs, taking into account past experience and the nature of the contracts.

Research and development costs

Research costs are expensed as incurred. Development costs are expensed as incurred unless they meet certain criteria under Canadian generally accepted accounting principles for deferral and amortization, which relate primarily to technological feasibility, identified future markets of the product, and availability of resources to complete the project. The Company has determined that none of its development costs to date have met these criteria.

Government assistance

Government assistance is recorded when receipt is reasonably assured as either a reduction of the cost of the applicable assets or a credit to the applicable expenses in the consolidated statement of operations and deficit as determined by the terms and conditions of agreements under which the assistance is provided to the Company. A liability is recorded when repayment of the assistance is considered probable.

Foreign currency translation

Transactions denominated in foreign currencies are translated to Canadian dollars at the rate prevailing at the time of the transactions. Monetary assets and liabilities denominated in a foreign currency are translated into Canadian dollars at the current rates in effect at the balance sheet date. The resulting exchange gains and losses are recognized in the consolidated statement of operations and deficit.

Stock-based compensation plans

The Company accounts for stock options using the fair value method calculated using the Black-Scholes option pricing model. For options granted to directors, officers and employees, the compensation cost is measured at fair value at the date of grant and is expensed to operations over the award's vesting period. For options granted to non-employees, the fair value is measured when performance is complete, a performance commitment is made or the options are fully vested and non-forfeitable, whichever is earliest, and the expense is recognized over the period in which the goods or services from the non-employees are received. A corresponding increase in

contributed surplus is recorded when stock options are expensed. When stock options are exercised, capital stock is credited by the sum of the consideration paid and the related portion previously recorded in contributed surplus.

Income taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method, future income taxes are recognized for the future income tax consequences attributable to differences between the financial statement carrying values and their respective income tax bases (temporary differences) and for the benefit of loss carry-forwards. Future tax assets and liabilities are measured using substantively enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period that includes the substantial enactment date. Future income tax assets are evaluated and if realization is not considered to be more likely than not, a valuation allowance is provided.

Financial instruments

a) Fair values

The fair values of cash and cash equivalents, restricted cash, short-term investments, accounts receivable, grants and funding receivables, accounts payable and accrued liabilities, bank debt, and obligations under capital lease approximate their carrying amounts due to the short-term nature of these instruments.

b) Credit risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company limits its exposure to credit risk by placing its cash and cash equivalents and short-term investments with high credit quality financial institutions and corporations. Concentration of credit risk with respect to accounts receivable is considered to be limited due to the credit quality of the customers comprising the Company's customer base. The maximum amount of credit risk exposure is limited to the carrying amount of the balances in the consolidated financial statements.

c) Foreign exchange risk

Predominantly all of the Company's sales are in United States dollars or Euros. The Company does not hold or issue financial instruments to manage its exposure to currency rate fluctuations relating to sales. For the year ended September 30, 2006, the Canadian dollar value of United States dollar denominated sales was \$5,896,343 (2005 - \$6,291,859) and Euro denominated sales was \$1,491,613 (2005 - \$nil).

d) Interest risk

The Company is exposed to interest risk on its bank debt for which the interest rates charged fluctuate based on the bank prime rate.

Comparative amounts

Comparative amounts have been reclassified, where necessary, to conform to the presentation adopted in the current year.

3 RESTRICTED CASH

During 2006, the Company was required to deposit cash with Comerica Bank as collateral to secure its obligations under irrevocable standby and documentary letters of credit. Restricted cash is released as the letters of credit are drawn upon or expire. Expiry dates of the letters of credit vary and extend to March 31, 2007. In addition, TD Bank requires a restricted deposit to secure corporate credit card debt. Restricted cash at September 30, 2006 of \$1,256,354 (2005 - \$102,396) relates to letters of credit of \$1,196,889 (2005 - \$43,896) and corporate credit card security of \$59,465 (2005 - \$58,500).

4 INVENTORIES

	2006 \$	2005 \$
Raw materials and supplies	502,472	350,182
Work-in-progress	2,604,919	607,759
Finished goods	403,117	987,935
	3,510,508	1,945,876

5 PROPERTY, PLANT AND EQUIPMENT

	2006		
	Cost \$	Accumulated amortization \$	Net \$
Test equipment	3,298,337	2,711,364	586,973
Computer equipment	2,251,760	2,092,415	159,345
Leasehold improvements	2,401,764	1,787,215	614,549
Lab and warehouse equipment	2,803,570	2,122,673	680,897
Manufacturing equipment	1,978,529	1,929,429	49,100
Office equipment	277,564	267,137	10,427
Furniture and fixtures	203,719	201,384	2,335
	13,215,243	11,111,617	2,103,626
	2005		
	Cost \$	Accumulated amortization \$	Net \$
Test equipment	3,089,280	2,234,803	854,477
Computer equipment	2,648,983	2,385,984	262,999
Leasehold improvements	2,416,508	2,375,406	41,102
Lab and warehouse equipment	2,476,721	1,732,674	744,047
Manufacturing equipment	1,935,635	1,872,230	63,405
Office equipment	277,574	263,869	13,705
Furniture and fixtures	201,529	197,250	4,279
	13,046,230	11,062,216	1,984,014

As at September 30, 2006, assets under capital lease with a cost of \$353,651 (2005 - \$775,725) and accumulated amortization of \$329,756 (2005 - \$634,228) are included in property, plant and equipment. Amortization expense for assets under capital lease recorded in the consolidated statement of operations and deficit for the year ended September 30, 2006 was \$106,095 (2005 - \$100,415).

6 ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

	2006 \$	2005 \$
Trade payables	3,462,599	1,403,893
Wages and benefits	467,741	325,082
Warranty provision	179,130	311,182
Accounting and legal costs	174,530	150,000
Taxes payable (GST, PST and VAT)	129,717	20,529
	4,413,717	2,210,686

7 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 a 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.

The line of credit is limited to 80% of eligible accounts receivable, subject to certain restrictions. This credit facility is payable upon demand. The variable interest rate for the line of credit is prime plus 0.50%. Interest is payable monthly, and the line of credit is renewable annually. As at September 30, 2006, no balance was drawn on this facility.

The variable interest rate of the term loans is prime plus 0.75%. Interest on Tranche 1 is initially payable monthly with 36 equal payments of principal plus interest beginning October 22, 2005. Interest on Tranche 2 is initially payable monthly with 30 equal payments of principal plus interest beginning January 22, 2007. As at September 30, 2006, the Company had drawn \$884,250 (2005 - \$650,517) on the term loans. Accrued interest payable as at September 30, 2006 was \$3,399 (2005 - \$2,776). Total interest expense was \$39,794 (2005 - \$10,439) for the year ended September 30, 2006. Draws can be made against the Tranche 2 term loan, to a maximum of US\$2 million, prior to June 22, 2007.

8 OBLIGATIONS UNDER CAPITAL LEASE

The Company leases computer equipment under a capital lease that expires in 2007 and bears interest at a rate of 5.5%. Interest paid during 2006 related to obligations under capital lease was \$6,243 (2005 - \$11,766), of which \$3,052 was expensed in the current year and \$3,191 was accrued in 2005. At September 30, 2006, future minimum payments under capital leases are \$nil (2005 - \$110,357).

9 SHARE CAPITAL AND CONTRIBUTED SURPLUS

a) Common shares - issued and outstanding

	Number of shares	Amount \$
Balance - September 30, 2004	4,922,992	2,795,830
Conversion of preferred shares Classes A, B and C as a result of initial public offering ("IPO")	23,738,018	75,229,847
Issuance of common shares as a result of IPO - net of share issuance costs of \$3,355,429	8,600,000	11,694,571
Exercise of share options	46,611	54,554
Balance - September 30, 2005	37,307,621	89,774,802
Issuance of common shares as a result of public offering - net of share issuance costs of \$1,589,499	14,815,000	18,410,750
Exercise of share options	270,444	834,650
Balance - September 30, 2006	52,393,065	109,020,202

b) Preferred shares - issued and outstanding

	Number of shares	Amount \$
Balance - September 30, 2004	-	-
Class A preferred shares	6,493,500	12,005,318
Class B preferred shares	9,034,088	52,449,884
Class C preferred shares	2,832,679	10,859,805
Converted to common shares as a result of IPO	(18,360,267)	(75,315,007)
Balance - September 30, 2005 and 2006	-	-

Included in the deficit balance at September 30, 2006 of \$95,045,478 (2005 - \$84,782,560) is non-cash accretion expense of \$13,631,542 (2005 - \$13,631,542) related to the preferred shares prior to conversion to common shares.

Immediately prior to the IPO, the Company reorganized its share capital whereby the existing classes of shares were converted into a single class of common shares. To complete this reorganization, certain terms of the preferred shares relating to automatic conversion rights were modified as follows: Class A preferred shares were converted into common shares on a 1:1 basis; Class B preferred shares were converted into common shares on a 1:1.277 basis; and Class C preferred shares were converted into common shares on a 1:1.856 basis. The modification of the share rights is accounted for on a fair value basis. The difference between the fair value of the share rights prior to the modification and the fair value of the modified share rights is accounted for as an adjustment to shareholders' equity. The modification of the Class A and B preferred shares resulted in an increase in deficit of \$1,705,093 and the conversion of the Class C preferred shares resulted in an increase in contributed surplus of \$1,790,253. The difference of \$85,160 was recorded as reduction to common shares. Both the charge to deficit and the increase in contributed surplus were included in the computation of loss per share for the year ended September 30, 2005.

c) Employee share options

Prior to 2004, the Company granted stock options to certain employees in lieu of cash bonuses and salary. As cash compensation was foregone by these employees, options of equivalent value were issued to them at an exercise price of \$0.001 per share. At September 30, 2006, the Company has 282,929 (2005 - 351,969) options in lieu of salary or bonus outstanding.

The Company first adopted an incentive stock option plan (the "Plan") in 1998 to provide its employees, officers, directors and consultants with options to purchase common shares of the Company. Immediately prior to the IPO on December 21, 2004, certain terms of the Plan were amended, and the Company's stock option pool was increased from 3,785,241 to 5,507,637 stock options (excluding any options that were issued as compensation for performance in lieu of salary or bonus). Under the terms of the Plan, stock options are granted with an exercise price not less than the fair market value of the Company's common shares on the date of grant. Stock options generally vest quarterly over four years. In no event can a stock option be exercisable for more than 10 years from the date of grant. At September 30, 2006, 437,921 (2005 - 822,254) options are available for issuance under the Company's Plan.

In 2004, the Company's Board of Directors and major preferred shareholders approved an award of 1,499,965 stock options under the Plan for key executives upon the successful completion of the IPO. These stock options were granted at an exercise price of \$1.75, vesting equally over four years at the end of each calendar quarter and expiring December 21, 2014. This resulted in \$1,379,968 of stock compensation expense, of which \$308,709 (2005 - \$344,955) has been charged to the consolidated statement of operations and deficit for the year ended September 30, 2006.

Furthermore, upon the closing of the IPO, the Company exchanged 1,270,398 stock options under the Plan, with exercise prices between \$3.10 and \$5.00, for 635,208 stock options with an exercise price of \$1.75, resulting in \$317,461 of stock compensation expense, of which \$19,528 (2005 - \$292,206) has been charged to the consolidated statement of operations and deficit for the year ended September 30, 2006 related to vested options.

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:

	2006 \$	2005 \$
Dividend yield	0%	0%
Expected volatility	56%	57%
Risk-free interest rate	4.04%	3.61%
Expected life of options	5 years	5 years

Share option activity since September 30, 2004 is presented below:

	Options	Weighted average exercise price \$
Outstanding - September 30, 2004 (2,825,188 shares exercisable)	3,886,863	1.85
Granted	1,704,810	1.74
Exercised	(46,611)	0.44
Forfeited	(718,202)	3.32
Outstanding - September 30, 2005 (3,082,400 shares exercisable)	4,826,860	1.38
Granted	735,674	1.09
Exercised	(270,444)	0.58
Forfeited	(355,031)	1.91
Outstanding - September 30, 2006 (3,413,604 shares exercisable)	4,937,059	1.34

Options outstanding - September 30, 2006

Exercise price range \$	Number of stock options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number of stock options exercisable	Weighted average exercise price \$
0.001	292,929	1.29	0.001	292,929	0.001
0.70 - 0.93	1,292,073	1.68	0.83	1,052,876	0.82
1.00 - 1.45	1,075,393	3.27	1.09	539,453	1.03
1.62 - 1.75	2,078,288	6.16	1.75	1,335,463	1.75
3.10	135,982	1.23	3.10	130,489	3.10
5.00	62,394	1.22	5.00	62,394	5.00
	4,937,059	4.69	1.34	3,413,604	1.31

The Company did not issue share options with an exercise price less than the estimated fair market value of a common share on the grant date for the year ended September 30, 2006 (2005 - nil). In 2006, the Company issued 735,674 (2005 - 1,704,810) share options with an exercise price equal to the fair market value of a common share on the grant date. These options had a weighted average exercise price of \$1.09 (2005 - \$1.74) and a weighted average fair value of \$0.56 (2005 - \$0.77). During 2006, \$492,302 (2005 - \$754,759) of stock compensation expense has been charged to the consolidated statement of operations and deficit related to the vesting of stock option awards and modifications made during and prior to September 30, 2006.

d) Share purchase warrants

During the year ended September 30, 2006, 430,000 share purchase warrants that had been issued to certain Agents upon closing of the IPO expired unexercised. As at September 30, 2006, 192,308 transferable share purchase warrants, issued as part of the agreement with the Canadian Federal Minister of Industry under

the Technology Partnerships Canada ("TPC") Program, remain outstanding (note 12(c)). These warrants are convertible into common shares at an exercise price of \$3.88 and are exercisable until June 6, 2008.

e) Contributed surplus

Changes in contributed surplus since September 30, 2004 are presented below:

	Amount \$
Balance - September 30, 2004	4,015,802
Warrants issued to Agents	120,400
Preferred share conversion	1,790,253
Stock-based compensation on share options issued to employees under the fair value method	754,759
Stock-based compensation allocated to common shares on exercise of share options	(34,085)
Balance - September 30, 2005	6,647,129
Stock-based compensation on share options issued to employees under the fair value method	492,302
Stock-based compensation allocated to common shares on exercise of share options	(676,659)
Balance - September 30, 2006	6,462,772

10 RESEARCH AND DEVELOPMENT

	2006 \$	2005 \$
Research and development costs	6,907,360	7,666,713
Government grants and funding from third parties under development agreements	(1,815,186)	(1,932,867)
	5,092,174	5,733,846

11 INCOME TAXES

a) Effective tax rate

The income tax expense (recovery) differs from the amount that would be computed by applying the combined federal and provincial statutory income tax rate of 34.12% (2005 - 34.25%) to income before income taxes. The reasons for the differences are as follows:

	2006 \$	2005 \$
Computed tax recovery	(3,502,000)	(3,260,000)
Increase (decrease) resulting from		
Permanent and other differences	329,000	268,000
Change in future income tax rates	-	844,000
Expiry of prior year losses	739,000	509,000
Share issuance costs	(542,000)	(971,000)
Change in valuation allowance	2,976,000	2,610,000
	-	-

b) Future tax assets and liabilities

	2006 \$	2005 \$
Share issuance costs	1,103,000	875,000
Non-capital loss carry-forwards	14,003,000	12,523,000
Scientific research and experimental development expenses	7,149,000	6,371,000
Non-refundable provincial tax credits	1,075,000	939,000
Reserves	726,000	653,000
Property, plant and equipment	1,251,000	970,000
Total future tax assets before valuation allowance	25,307,000	22,331,000
Valuation allowance	(25,307,000)	(22,331,000)
Net future tax asset	-	-

In assessing the realizability of future tax assets, management considers whether it is more likely than not that some portion or all of the future tax assets will be realized. The ultimate realization of future tax assets depends upon the generation of future taxable income during the periods in which those temporary differences become deductible. As management believes there is sufficient uncertainty regarding the realization of future tax assets, a full valuation allowance has been provided.

The Company has non-capital losses carried forward of approximately \$41,041,000 available to reduce taxable income of future years, the benefit of

which has not been recorded in the accounts, which expire as follows:

	\$
2007	4,873,000
2008	6,129,000
2009	3,965,000
2010	8,379,000
2014	4,897,000
2015	5,885,000
2016	6,913,000
	41,041,000

The Company has scientific research and experimental development expenses of \$20,951,000 (2005 - \$18,671,000) which are available to be carried forward indefinitely and deducted against future taxable income otherwise calculated.

- c) As of September 30, 2006, the Company also has investment tax credits of approximately \$7,697,016 (2005 - \$6,576,000) available to offset future Canadian federal and provincial income taxes payable. The investment tax credits expire commencing 2010. The potential benefit of the investment tax credits has not been recognized in the consolidated accounts.

12 COMMITMENTS AND CONTINGENCIES

a) Leases

At September 30, 2006, the Company is committed to make the following minimum operating lease payments related to premises and office equipment:

	\$
2007	508,786
2008	513,331
2009	91,332
2010 and thereafter	144,666
	1,258,115

b) Letters of credit

During 2006, the Company had banks issue letters of credit on its behalf to meet its performance obligations on customer contracts and to secure future payments to a vendor. At September 30, 2006, \$1,158,479 (2005 - \$43,896) of these letters of credit is outstanding, with varying expiry dates extending to March 31, 2007.

c) TPC Programs

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 Fast 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 \$7,760,083 up to September 30, 2006 (2005 - \$5,856,857). Of this amount, \$6,550,322 (2005 - \$4,743,887) has been allocated against research and development expenses, \$709,761 (2005 - \$612,970) has been allocated against the cost of property, plant and equipment, and \$500,000 (2005 - \$500,000) is reflected as share purchase warrants. For the year ended September 30, 2006, \$1,806,436 (2005 - \$1,840,623) has been allocated against research and development expenses and \$96,791 (2005 - \$195,951) has been allocated against the cost of property, plant and equipment. The agreement further states 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 by 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 September 30, 2006, \$146,800 (2005 - \$35,040) has been accrued as a liability. Under the agreement, royalties are due on January 31 of each year, beginning in 2007.

Pulsar Pressure Swing Adsorption project

On March 31, 1999, 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 Pulsar Pressure Swing Adsorption project.

Pursuant to the agreement, total project costs for the period from October 1, 1998 to March 31, 2002 were to be shared, subject to annual contribution limits, such that the Minister's contribution would not exceed the lesser of 35% of eligible project costs and \$4,947,330.

The Company received contributions aggregating \$4,762,503. The agreement further provides that the contributions are repayable solely based on a royalty of 1.8% of gross project revenues and

revenues from fuel cell related products to a maximum cumulative repayment of \$8.75 million. Cumulative repayments of \$32,952 (2005 - \$25,992) have been made to September 30, 2006. Any amounts ultimately determined to be repayable are accrued as a liability when the project revenues are known and reasonably estimable. As of September 30, 2006, \$13,273 (2005 - \$11,537) has been accrued as a liability. The agreement terminates on the later of the date of payment of all amounts due to the Minister and 2015.

d) Natural Resources Canada Agreement

In January 2005, the Company received a grant from the Government of Canada under the Department of Natural Resources Efficiency and Alternative Energy Program to support the development of structured adsorbent that will possess enhanced properties to assist in high purity hydrogen separation. Total funding received by the Company of \$225,000 was recorded as a credit of \$85,349 to research and development and a credit of \$139,651 to property, plant and equipment in fiscal 2005. The agreement provides that the Minister shall provide the Company with financial contributions based on the aforementioned limitations and such contributions are repayable solely based on 0.12% of gross project revenues through March 31, 2015, to a maximum cumulative repayment of \$225,000, whichever occurs first. Any amounts ultimately determined to be repayable are accrued as a liability when the project revenues are known and reasonably estimable. To date, no such project revenue has been recorded.

In January 2004, the Company received a grant from the Government of Canada under the Department of Natural Resources Efficiency and Alternative Energy Program to support the development of a device that increases the efficiency of a High Temperature Fuel Cell system and permits the co-production of hydrogen. Total funding received by the Company of \$193,944 was recorded as a credit of \$142,350 to research and development and a credit of \$51,594 to property, plant and equipment in fiscal 2004. The agreement provides that the Minister shall provide the Company with financial contributions based on the aforementioned limitations and such contributions are repayable solely based on 0.12% of gross project revenues through March 31, 2014, to a maximum cumulative repayment of \$193,944, whichever occurs first. Any amounts ultimately determined to be repayable are accrued as a liability when the project revenues are known and reasonably estimable. To date, no such project revenue has been recorded.

- e) Exxon Mobil Research and Engineering Company
Effective October 2003, the Company entered into a multi-year Joint Development Agreement with Exxon Mobil Research and Engineering Company ("EMRE") to evaluate specific projects and to develop, commercialize

and market purification products for a range of refinery and petrochemical applications. Under this agreement, the Company is granted certain exclusive rights to inventions in the field of adsorption based separation or enrichment and EMRE is granted certain exclusive rights to inventions in the field of petroleum and petrochemical processes. The agreement further details how costs for development projects are shared between the parties, and provides for revenue sharing between the parties should resulting products be commercialized for one or more applications.

In May 2006, the Company entered into a multi-year commercialization agreement ("Commercialization Agreement") with EMRE for the marketing and commercialization of the H-6200 hydrogen purifier, the first product developed under the Joint Development Agreement. Under the terms of the Commercialization Agreement, EMRE will lead the marketing of the H-6200 hydrogen purifier to oil refineries and petrochemical plants. The Company retains sole responsibility for negotiating and executing agreements with customers, as well as for manufacturing and order fulfillment. The Company will pay EMRE a portion of the commercial gain from the sale of H-6200 hydrogen purifier units and any associated lease of adsorbent beds based on EMRE's contribution to the research, development and commercialization of the H-6200 hydrogen purifier product.

f) Director and officer indemnification

The Company's directors and officers are covered under a directors' and officers' insurance policy. The aggregate limit of liability applicable to those insured directors and officers under the policy is \$10 million. Under this policy, the Company has reimbursement coverage to the extent that the Company has indemnified a director or officer in excess of a deductible of \$250,000 for each loss related to securities claims and \$100,000 for other losses. The Company's bylaws also provide for the indemnification of the directors and officers from and against liability and costs in respect of any action or suit against them in connection with the execution of their duties of office, subject to certain limitations.

13 SEGMENTED INFORMATION

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

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

	2006 \$	2005 \$
Revenue		
Europe	3,812,670	253,216
United States	2,289,881	5,656,316
Asia	1,040,685	238,723
Canada	414,857	144,054
	7,558,093	6,292,309

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

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

	2006 \$	2005 \$
Customer A	839,743	-
Customer B	5,337,481	4,107,165
Customer C	-	823,109

14 LOSS PER SHARE

Loss per share is calculated using the weighted average number of common shares outstanding for the year of 42,426,280 (2005 - 30,017,856). Outstanding convertible preferred shares, share options and warrants to purchase common shares were not included in the computation of diluted loss per share as their impact is anti-dilutive.

15 SUPPLEMENTAL CASH FLOW INFORMATION

	2006 \$	2005 \$
Supplemental cash flow information		
Cash paid for interest	45,416	19,436
Cash received for interest	255,787	224,988
Non-cash operating, investing and financing activities		
Issuance of common shares on exercise of stock options	676,659	34,085
Property, plant and equipment included in accrued liabilities	317,645	-
Property, plant and equipment reallocated to inventory	18,297	-

TRADING SYMBOLS AND EXCHANGES

Toronto Stock Exchange: QAR
AIM (London Stock Exchange Plc.): QAR

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BOARD OF DIRECTORS

(pictured from left to right)

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