Xebec Adsorption Inc.

Consolidated Financial Statements
December 31, 2012 and 2011
(expressed in Canadian dollars)

April 1, 2013

Independent Auditor's Report

To the Shareholders of
Xebec Adsorption Inc.

We have audited the accompanying consolidated financial statements of Xebec Adsorption Inc. and its subsidiaries, which comprise the consolidated statements of financial position as at December 31, 2012 and 2011 and the consolidated statements of earnings (loss), comprehensive income (loss), changes in equity (deficiency) and cash flows for the years then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l.
1250 René-Lévesque Boulevard West, Suite 2800, Montréal, Quebec, Canada H3B 2G4
T: +1 514 205 5000, F: +1 514 876 1502

"PwC" refers to PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l., an Ontario limited liability partnership.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Xebec Adsorption Inc. and its subsidiaries as at December 31, 2012 and 2011 and their financial performance and their cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP[1]

---

[1] CPA auditor, CA, public accountancy permit No. A111799

Xebec Adsorption Inc.

Consolidated Statements of Financial Position

(expressed in Canadian dollars)

	As at December 31, 2012 $	As at December 31, 2011 $
Assets		
Current assets		
Cash	1,344,114	389,090
Trade and other receivables (note 7)	3,936,746	2,444,842
Inventories (note 8)	1,662,494	1,365,260
Short-term portion of balance of sale (note 15b))	200,000	-
Investment tax credits receivable	75,000	75,000
Other current assets	425,102	329,292
Total current assets	7,643,456	4,603,484
Non-current assets		
Balance of sale (note 15b))	600,000	800,000
Property, plant and equipment (note 9)	369,976	548,671
Intangible assets (note 10)	978,258	3,988,317
Goodwill (note 10)	142,616	342,616
Total non-current assets	2,090,850	5,679,604
Total assets	9,734,306	10,283,088
Liabilities		
Current liabilities		
Bank loan (note 11)	166,952	500,000
Trade payables (note 12)	3,799,491	4,547,515
Accrued liabilities	1,144,539	1,195,825
Deferred revenues (note 13)	1,067,987	2,506,474
Current portion of long-term debt and obligation (note 15a))	76,474	141,786
Current portion of government royalty program obligation (note 15c))	365,959	195,949
Provisions (note 14)	161,692	390,549
Total current liabilities	6,783,094	9,478,098
Non-current liabilities		
Loan from a related party (note 25)	-	23,562
Long-term debt and obligation (note 15a))	117,649	236,729
Government royalty program obligation (note 15c))	714,853	752,972
Government assistance	22,083	27,083
Deferred rent	32,980	6,596
Provisions (note 14)	326,308	65,169
Total non-current liabilities	1,213,873	1,112,111
Total liabilities	7,996,967	10,590,209
Equity (Deficiency)		
Share capital (note 16)	19,732,623	19,802,272
Contributed surplus	2,316,580	2,168,550
Accumulated other comprehensive loss	(48,870)	(71,521)
Deficit	(20,528,866)	(22,211,793)
	1,471,467	(312,492)
Non-controlling interest (note 5)	265,872	5,371
Total equity	1,737,339	(307,121)
Total liabilities and equity	9,734,306	10,283,088

The accompanying notes are an integral part of these consolidated financial statements.

Approved by the Board of Directors

(signed) Kurt Sorchak Director

(signed) John Shakeshaft Director

Xebec Adsorption Inc.

Consolidated Statements of Earnings (Loss)
For the years ended December 31, 2012 and 2011
(expressed in Canadian dollars)

	2012 $	2011 $
Revenue	15,179,121	14,203,463
Cost of goods sold	12,032,774	9,999,460
Gross margin	3,146,347	4,204,003
Research and development expenses (note 19)	142,585	550,345
Selling and administrative expenses	6,501,102	6,846,178
Foreign exchange loss (gain)	47,834	(107,050)
Gain on disposition of assets (note 6)	(6,445,769)	(2,275,092)
Loss on loan to a joint venture (note 5)	-	138,105
	245,752	5,152,486
Operating income (loss)	2,900,595	(948,483)
Finance income	(47,561)	(9,410)
Finance expense (note 20)	1,009,303	517,877
Finance costs – net	961,742	508,467
Net income (loss) for the year	1,938,853	(1,456,950)
Earnings (loss) attributable to:		
Shareholders of the Company	1,682,927	(1,447,123)
Non-controlling interest	255,926	(9,827)
	1,938,853	(1,456,950)
Earnings (loss) per share		
Basic (note 16)	0.04	(0.04)
Diluted (note 16)	0.04	(0.04)

The accompanying notes are an integral part of these consolidated financial statements.

Xebec Adsorption Inc.

Consolidated Statements of Comprehensive Income (Loss)
For the years ended December 31, 2012 and 2011
(expressed in Canadian dollars)

	2012 $	2011 $
Net income (loss) for the year	1,938,853	(1,456,950)
Other comprehensive income (loss)		
Cumulative translation adjustment	27,226	(162,784)
Comprehensive income (loss) for the year	1,966,079	(1,619,734)
Attributable to:		
Shareholders of the Company	1,705,578	(1,591,266)
Non-controlling interest (note 5)	260,501	(28,468)
	1,966,079	(1,619,734)

The accompanying notes are an integral part of these consolidated financial statements.

Xebec Adsorption Inc.

Consolidated Statements of Changes in Equity (Deficiency)
For the years ended December 31, 2012 and 2011
(expressed in Canadian dollars)

	Number		Amount						
	Common shares	Warrants	Share capital – Common shares and warrants $	Contributed surplus $	Accumulated other comprehensive income (loss) $	Deficit $	Equity attributable to the Company $	Non-controlling interest $	Total $
Balance – January 1, 2011	39,363,867	15,456,424	19,964,218	1,841,741	72,622	(20,764,670)	1,113,911	-	1,113,911
Net loss for the year	-	-	-	-	-	(1,447,123)	(1,447,123)	(9,827)	(1,456,950)
Other comprehensive loss	-	-	-	-	(144,143)	-	(144,143)	(18,641)	(162,784)
Comprehensive loss for the year	-	-	-	-	(144,143)	(1,447,123)	(1,591,266)	(28,468)	(1,619,734)
Expired warrants (note 16)	-	(4,798,288)	(161,946)	161,946	-	-	-	-	-
Share-based compensation	-	-	-	164,863	-	-	164,863	-	164,863
Non-controlling interest at business acquisition	-	-	-	-	-	-	-	33,839	33,839
Balance – December 31, 2011	39,363,867	10,658,136	19,802,272	2,168,550	(71,521)	(22,211,793)	(312,492)	5,371	(307,121)
Balance – January 1, 2012	39,363,867	10,658,136	19,802,272	2,168,550	(71,521)	(22,211,793)	(312,492)	5,371	(307,121)
Net income (loss) for the year	-	-	-	-	-	1,682,927	1,682,927	255,926	1,938,853
Other comprehensive loss	-	-	-	-	22,651	-	22,651	4,575	27,226
Comprehensive loss for the year	-	-	-	-	22,651	1,682,927	1,705,578	260,501	1,966,079
Expired warrants (note 16)	-	(566,250)	(69,649)	69,649	-	-	-	-	-
Share-based compensation	-	-	-	78,381	-	-	78,381	-	78,381
Balance – December 31, 2012	39,363,867	10,091,886	19,732,623	2,316,580	(48,870)	(20,528,866)	1,471,467	265,872	1,737,339

Accumulated other comprehensive income relates solely to cumulative translation adjustments.

The accompanying notes are an integral part of the consolidated financial statements.

Xebec Adsorption Inc.

Consolidated Statements of Cash Flows

For the years ended December 31, 2012 and 2011

(expressed in Canadian dollars)

	2012 $	2011 $
Cash flows from		
Operating activities		
Net income (loss) for the year	1,938,853	(1,456,950)
Items not affecting cash		
Amortization of property, plant and equipment	142,652	385,073
Amortization of intangible assets	325,619	512,597
Loss (gain) on disposal of property, plant and equipment	192	(2,275,092)
Gain on disposition of assets (note 6)	(6,445,961)	-
Gain on debt forgiveness	(134,980)	(101,701)
Government assistance	(5,000)	(5,000)
Unrealized foreign exchange loss on loan to a joint venture and restricted cash	-	(1,603)
Loss on loan to a joint venture	-	138,105
Accretion and revaluation of government royalty program obligation	921,891	257,382
Stock-based compensation expense	78,381	164,863
Deferred rent	26,384	-
	(3,151,969)	(2,382,326)
Changes in non-cash working capital components relating to operations		
Trade and other receivables	(1,491,904)	374,323
Inventories	(297,234)	1,457,662
Investment tax credits receivable	-	28,489
Other current assets	(95,810)	(226,618)
Trade payables	(613,044)	(1,137,581)
Accrued liabilities	(51,286)	(269,126)
Deferred revenues	(1,289,008)	(144,852)
Income taxes recoverable	-	(8,286)
Other operating liabilities	32,282	(885,566)
	(3,806,004)	(811,555)
	(6,957,973)	(3,193,881)
Investing activities		
Acquisition of property, plant and equipment	(133,105)	(2,191)
Acquisition of intangible assets	(84,972)	(16,972)
Net proceeds from disposal of property, plant and equipment	19,000	2,468,981
Proceeds from disposal of assets (note 6)	9,414,519	-
Cash acquired on acquisition of a business	-	47,066
Decrease in restricted cash	-	576,092
	9,215,442	3,072,976
Financing activities		
Repayment of bank loan	(333,048)	-
Increase in long-term debt	9,807	9,568
Repayment of loan from a shareholder of joint venture	(24,123)	23,562
Repayment of long-term debt	(194,199)	(1,742,329)
Repayment of government royalty program obligation	(790,000)	-
	(1,331,563)	(1,709,199)
Effect of exchange rate changes on cash	29,118	(43,079)
Increase (decrease) in cash during the year	955,024	(1,873,183)
Cash – Beginning of year	389,090	2,262,273
Cash – End of year	1,344,114	389,090
Additional information		
Interest paid	89,011	260,108

The accompanying notes are an integral part of the consolidated financial statements.

1 Nature of business and liquidity risk

a) Nature of business

Xebec Adsorption Inc. ("Xebec" or the "Company") is a global provider which specializes in the design and manufacture of cost-effective, environmentally responsible, purification, separation, dehydration, and filtration equipment for gases and compressed air. Xebec's main product lines are: Biogas Plants for the purification of biogas from agricultural digesters, landfill sites and waste water treatment plants, Natural Gas Dryers for NGV refuelling stations, Associated Gas Purification Systems which enable diesel displacement on drilling sites, and Hydrogen Purification Systems for fuel cell and industrial applications. The Company is incorporated and domiciled in Canada and is listed on the Toronto Stock Exchange under the symbol XBC. The address of its registered office is 730 Industriel Boulevard, Blainville, Quebec, Canada.

b) Liquidity risk

The Company has realized an operating profit of $2,900,595, had cash outflows from operations of $6,957,973 for the year ended December 31, 2012 and finished the year with cash amounting to $1,344,114, working capital of $860,362 and had access to credit facilities totalling $1,500,000 of which only $166,952 has been used. The Company is currently in breach of its TPC agreement but obtained a four month extension (note 29b)). During the fourth quarter of 2012, management undertook various initiatives and developed a plan to manage its operating and liquidity risks in light of prevailing economic conditions. Management is also currently seeking alternative financings for its operations such as asset-based lending facilities. The Company has prepared a budget for 2013 for which management believes the assumptions are reasonable. Achieving budgeted results is dependent on improving the volume of revenues, delivering on sales and contracts schedules, meeting expected overall operating margin levels and controlling general and administrative costs. Management expects to meet its budget and to have enough liquidity to fund operations to at least beyond December 31, 2013.

The Company is thus faced with uncertainties that may have an impact on future operating results and liquidity. These uncertainties include reduced spending in biogas projects reflecting the weakness of the market, fluctuations in foreign currency rates and achieving the Company's business plan goals as mentioned in the previous paragraph, which includes the development of a new business segment. While management believes it has developed planned courses of action to mitigate operating and liquidity risks, there is no assurance that management will be able to achieve its business plan and maintain the necessary liquidity level if events or conditions develop that are not consistent with management's expectations, key budget assumptions for 2013 and planned courses of action. Therefore, the Company may require additional external funding and there is no assurance that it would be successful. It is possible that future changes in capital markets conditions could result in such funding not being available when required or at acceptable costs. The Company is unable to predict the possible effects, if any, of such uncertainties and the potential adjustments to the carrying values of assets and liabilities that could be needed should the Company have insufficient liquidity. Such adjustments could be material.

2 Basis of preparation

The Company prepares its financial statements in accordance with generally accepted accounting principles in Canada ("GAAP") as set out in the Handbook of the Canadian Institute of Chartered Accountants - Part I ("CICA Handbook") which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

These financial statements were approved for issue by the Board of Directors of the Company on April 1st, 2013.

These financial statements are based on the accounting policies as described below. These policies have been consistently applied to all the periods presented, unless otherwise stated.

3 Significant accounting policies

Basis of measurement

These consolidated financial statements have been prepared under the historical cost convention, except for the revaluation of certain financial assets and financial liabilities to fair value.

Basis of consolidation

These consolidated financial statements include the accounts of the Company and its subsidiaries. Subsidiaries are entities controlled by the Company. Control exists when Xebec is able to govern the financial and operating activities of those entities to generate returns for the Company. Intercompany transactions, balances and unrealized gains and losses on transactions between different entities within the Company are eliminated. Subsidiaries include Xebec Adsorption (Shanghai) Co. Ltd., which is wholly owned, and Xebec Adsorption South East Asia PTE. Ltd., which is 56.49% owned. Subsidiaries are fully consolidated from the date on which control is obtained by the Company and are deconsolidated from the date that control ceases.

Non-controlling interest represents equity interest in a subsidiary owned by an outside party. The share of net assets of subsidiaries attributable to non-controlling interest is presented as a component of equity. Its share of net earnings and comprehensive income is recognized directly in equity. Changes in the Company's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Trade receivables

Trade receivables are amounts due from customers for merchandise sold or services performed in the ordinary course of business. If collection is expected in one year or less (or in the normal operating cycle of the business if longer), they are classified as current assets. If not, they are presented as non-current assets. Trade receivables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less provision for impairment.

Inventories

Inventories are stated at the lower of cost and net realizable value for raw materials, 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 (based on normal operating capacity). Net realizable value is the estimated selling price less applicable selling expenses. Inventories are recorded net of any obsolescence provision.

A new assessment is made in each subsequent year when inventories are adjusted to net realizable value. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realizable value because of changed economic circumstances, the amount of the writedown is reversed (i.e., the reversal is limited to the amount of the original writedown) so that the new carrying amount is the lower of cost and the revised net realizable value.

Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation and accumulated impairment losses. Cost includes expenditures that are directly attributable to the acquisition of the asset. Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying amount of a replaced asset is derecognized when replaced. Repairs and maintenance costs are charged to the consolidated statement of loss during the year in which they are incurred.

The major categories of property, plant and equipment are depreciated on a straight-line basis as follows:

Machinery and equipment	3 to 10 years
Office furniture and equipment	5 years
Computers	3 years
Moulds	5 years
Vehicles	5 years
Leasehold improvements	Lesser of economic life and lease term

The Company allocates the amount initially recognized in respect of an item of property, plant and equipment to its significant components and depreciates each such component separately. Residual values, method of depreciation and useful lives of the assets are reviewed annually and adjusted if appropriate.

Gains and losses on disposals of property, plant and equipment are determined by comparing the proceeds with the carrying amount of the asset and are included as part of other gains and losses in the consolidated statement of earnings.

Identifiable intangible assets

The Company's intangible assets include patents, customer relations, software and engineering drawings. These assets are capitalized and amortized on a straight-line basis in the consolidated statement of loss over the period of their expected useful lives.

Patent costs are amortized over fifteen years. Customer relations are amortized over six years. Engineering drawings, consisting of engineering costs incurred to develop product plans, and software are amortized over a period of three years.

Impairment of non-financial assets

Property, plant and equipment and intangible assets are tested for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Long-lived assets that are not amortized are subject to an annual impairment test. For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units or CGUs). The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use (being the present value of the expected future cash flows of the relevant asset or CGU). An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount.

The Company evaluates impairment losses, other than goodwill impairment, for potential reversals when events or circumstances warrant such consideration.

Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Company's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to CGUs for the purpose of impairment testing. The allocation is made to those CGUs that are expected to benefit from the business combination in which the goodwill arose, identified according to operating segment.

Trade payables

Trade payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Accounts payable are classified as current liabilities if payment is due within one year or less. If not, they are presented as non-current liabilities. Trade payables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method.

Provisions

Provisions for restructuring costs, warranties and legal claims, where applicable, are recognized in accrued liabilities when the Company has a present legal or constructive obligation as a result of past events, it is more likely than not that an outflow of resources will be required to settle the obligation, and the amount can be reliably estimated. Provisions are measured at management's best estimate of the expenditure required to settle the obligation at the end of the reporting year, and are discounted to present value where the effect is material. The Company performs evaluations to identify onerous contracts and, where applicable, records provisions for such contracts.

During the normal course of its operations, the Company assumes certain maintenance and repair costs under warranties offered on natural gas equipment, biogas and hydrogen purification equipment. The warranties cover a period ranging from 12 to 18 months. A liability for the expected cost of the warranty-related claims is established when the product is delivered and completed. In estimating the warranty liability, historical material replacement costs and the associated labour costs are considered. Revisions are made when actual experience differs materially from historical experience.

Financial instruments

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

Cash	Loans and receivables
Trade and other receivables	Loans and receivables
Loan to a joint venture	Loans and receivables
Bank loan	Other financial liabilities
Trade payables and accrued liabilities	Other financial liabilities
Long-term debt	Other financial liabilities
Government royalty program obligation	Other financial liabilities
Subordinated loan	Other financial liabilities

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are initially recognized at the amount expected to be received, less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment.

Other financial liabilities are initially measured at fair value and subsequently at amortized cost using the effective interest method. Financial liabilities are classified as current liabilities if payment is due within 12 months. Otherwise, they are presented as non-current liabilities.

The Company classifies embedded derivative financial instruments as fair value through profit or loss, and values them at fair value at the end of each year, with changes recorded in other income. The Company does not designate these derivative financial instruments as hedges.

Impairment of financial assets

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired. If such evidence exists, the Company recognizes an impairment loss.

The loss on financial assets carried at amortized cost is the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent years if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized. Impairment losses on available-for-sale equity instruments are not reversed.

Government royalty program obligations

The Company receives from time to time, from different government agencies, funding designed to promote economic growth, create jobs and wealth, and support sustainable development. In some of these arrangements, the Company has a contractual obligation to repay the contributions to the government agency, with repayments determined as a percentage of specified revenues over a contractually defined royalty year. Such arrangements are recognized as government royalty program obligations at initial recognition when the contribution is received. These obligations are estimated based on future projections, discounted using a rate that reflects the liability-specific risks. Over time, interest expense is recognized as a result of accretion of the long-term obligations, while royalty payments are recorded against the obligations. Subsequently, the government royalty program obligations are remeasured when the future projections initially used to measure the obligations are revised using the original discount rate. Resulting changes in the carrying amount of these obligations are recognized in the consolidated statement of loss as Finance expense.

Share capital

Common shares are classified as equity. Incremental costs directly attributable to the issuance of shares are recognized as a deduction from share capital.

Revenue recognition

The Company earns revenues mainly from the sale of natural gas dryers and hydrogen purification solutions ("commercial equipment"). The Company recognizes revenue on commercial equipment sales when it is probable that the economic benefits will flow to the Company and delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. These criteria are generally met at the time the product is shipped and delivered to the customer and, depending on the delivery conditions, title and risk have passed to the customer and acceptance of the product has been obtained. Provisions are established for estimated product returns and warranty costs at the time revenue is recognized. Cash received in advance of all of these revenue recognition criteria being met is recorded as deferred revenue.

Revenues from long-term production-type contracts such as biogas purification equipment and engineering service contracts are determined under the percentage-of-completion method whereby revenues are recognized based on the costs incurred to date in relation to the total expected costs of a contract (costs being composed mainly of materials and labour). 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 recorded 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 goods sold in the period in which the loss becomes evident and reasonably estimable.

Revenues from licensing arrangements are recognized when it is probable that the economic benefits will flow to the Company and that the sales price is fixed or determinable, and collectibility is reasonably assured. These criteria are generally met at the time the contract is signed and title and risk have passed to the customer.

Revenue is measured based on the price specified in the sales contract, net of discounts and estimated returns at the time of sale. Historical experience is used to estimate and provide for discounts and returns.

Government assistance

Non-refundable grants relating to property, plant and equipment are accounted for as deferred government assistance and amortized on the same basis as the related assets.

Research and experimental development tax credits are recognized using the cost reduction method when there is reasonable assurance of their recovery. Investment tax credits are subject to the customary approvals by the pertinent tax authorities. Adjustments, if required, are reflected in the year when such assessments are received.

Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the consolidated statement of loss on a straight-line basis over the lease term.

Leases where the Company has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalized at the lease's commencement at the lower of the fair value of the leased property and the present value of the minimum lease payments.

Each lease payment is allocated between the liability and finance charges. The interest element of the finance cost is charged to the consolidated statement of loss over the lease year so as to produce a constant yearly rate of interest on the remaining balance of the liability for each year. Assets acquired under finance leases are depreciated over the shorter of the useful life of the asset and the lease term.

Stock-based compensation plans

The Company accounts for stock options using the fair value method. Each tranche in an award is considered a separate award with its own vesting year and grant date fair value. Fair value of each tranche is measured at the date of grant using the Black-Scholes option pricing model. The Black-Scholes model was developed to estimate the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, this model usually requires the input of assumptions, including expected stock price volatility. For options granted to directors, officers and employees of the Company, compensation expense is recognized over the tranche's vesting period by increasing contributed surplus based on the number of awards expected to vest. The number of awards expected to vest is reviewed at least annually. For options granted to non-employees, the transaction is measured with reference to the fair value of the goods or services when received. Related expense is recognized over the period during which the goods or services from the non-employees are received. A corresponding increase is recorded in contributed surplus when stock options are expensed. When stock options are exercised, capital stock is credited by the sum of the consideration paid and the related amount previously recorded in contributed surplus.

Research and development expenses

Research expenses are charged to expenses as incurred. Development expenses are charged to expenses as incurred unless they meet criteria for deferral and amortization. To date, no development expenses have been deferred.

Income taxes

Income tax comprises current and deferred tax. Income tax is recognized in the consolidated statement of earnings (loss) except to the extent that it relates to items recognized directly in other comprehensive income or equity, in which case the income tax is also recognized directly as such.

Current income tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the end of the reporting year, and any adjustment to tax payable in respect of previous years.

In general, deferred income tax is recognized in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined on a non-discounted basis using tax rates and laws that have been enacted or substantively enacted at the statement of financial position date and are expected to apply when the deferred tax asset or liability is settled. Deferred income tax assets are recognized to the extent that it is probable that the assets can be recovered.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are presented as non-current.

Earnings per share

Basic earnings per share (“EPS”) is calculated by dividing the net income for the year attributable to equity owners of the Company by the weighted average number of common shares outstanding during the year.

Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The number of shares included with respect to options, warrants and similar instruments is computed using the treasury stock method, which assumes that if all dilutive securities had been exercised at the later of the beginning of the year and the date of issuance, as the case may be, the proceeds would be used to purchase common shares of the Company at the average market value during the year.

Foreign currency translation

a) Functional and presentation currency

Items included in the financial statements of each consolidated entity in the Company group are measured using the currency of the primary economic environment in which the entity operates (the “functional currency”). The consolidated financial statements are presented in Canadian dollars, which is the Company’s functional currency.

The financial statements of entities that have a functional currency different from that of the Company (“foreign operations”) are translated into Canadian dollars as follows: assets and liabilities – at the closing rate at the date of the statement of financial position, and income and expenses – at the average rate of the year (to the extent this is considered a reasonable approximation to actual rates). All resulting changes are recognized in other comprehensive income as cumulative translation adjustment.

When an entity disposes of its entire interest in a foreign operation, or loses control, joint control or significant influence over a foreign operation, the foreign currency gains or losses accumulated in other comprehensive income related to the foreign operation are recognized in profit or loss. If an entity disposes of part of an interest in a foreign operation which remains a subsidiary, a proportionate amount of foreign currency gains or losses accumulated in other comprehensive income related to the subsidiary is reallocated between controlling and non-controlling interests.

b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Generally, foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in currencies other than an operation's functional currency are recognized in the consolidated statement of income.

Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the management committee.

Accounting standards issued but not yet applied that have relevance to the Company

Unless otherwise noted, the following revised standards and amendments are effective for the Company for annual periods beginning on or after January 1, 2013 with earlier application permitted. The Company does not expect to adopt any of these standards before their effective date. Except as otherwise indicated, based upon current facts and circumstances, the Company does not expect a material impact on its consolidated statement of earnings (loss) and financial position upon the adoption of those standards which are effective on January 1, 2013. The Company continues to evaluate the impact of these standards on its consolidated financial statements.

(i) IFRS 9, Financial Instruments, issued in November 2009, is mandatory for accounting periods beginning after January 1, 2015 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in IAS 39, Financial Instruments: Recognition and Measurement, for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, Financial Instruments: Recognition and Measurement, except that fair value changes due to credit risk for liabilities designated at fair value through profit or loss are generally recorded in other comprehensive income. IFRS 9 is applicable to the Company for the year beginning on January 1, 2015, with earlier application permitted.

(ii) IFRS 10, Consolidated Financial Statements, requires an entity to consolidate an investee when it has power over the investee, is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC 12, Consolidation—Special Purpose Entities, and parts of IAS 27, Consolidated and Separate Financial Statements.

(iii) IFRS 11, Joint Arrangements, requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation, the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures, and SIC 13, Jointly Controlled Entities—Non-monetary Contributions by Venturers.

(iv) IFRS 12, Disclosure of Interests in Other Entities, establishes disclosure requirements for interests in other entities such as subsidiaries, joint arrangements, associates and unconsolidated structured entities. The standard carries forward existing disclosures and also introduces significant additional disclosures that address the nature of, and risks associated with, an entity's interests in other entities.

(v) IFRS 13, Fair Value Measurement, is a comprehensive standard for fair value measurement and disclosure for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and does not always reflect a clear measurement basis or consistent disclosures.

(vi) IAS 1, Presentation of Financial Statements, has been amended to require entities to separate items presented in other comprehensive income into two groups, based on whether or not items may be recycled in the future. Entities that choose to present other comprehensive income items before tax will be required to show the amount of tax related to the two groups separately.

4. Significant accounting judgments and estimation uncertainties

Critical accounting estimates and judgments

The Company makes estimates and assumptions concerning the future that will, by definition, seldom equal actual results. The following are the estimates and judgments applied by management that most significantly affect the Company's consolidated financial statements. These estimates and judgments have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

i. Inventories must be valued at the lower of cost and net realizable value.

   A writedown of the inventory will occur when its estimated market value less applicable variable selling expenses is below its carrying amount. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. This estimation process involves significant management judgment and is based on the Company's assessment of market conditions for its products determined by historical usage, estimated future demand and, in some cases, the specific risk of loss on specifically identified inventory. Any change in the assumptions used in assessing this valuation will impact the carrying amount of the inventory and have a corresponding impact on cost of goods sold.

ii. Impairment of customer relations

   The Company performs a test for customer relations impairment when there is any indication whether customer relations has suffered any impairment in accordance with the accounting policy stated in the summary of significant accounting policies of these financial statements. The recoverable amounts of customer relations have been determined based on value-in-use calculations. The value in use calculation is based on a discounted cash flow model. These calculations require the use of estimates and forecasts of future cash flows. Qualitative factors, including strength of customer relationships, degree of variability in cash flows as well as other factors are considered when making assumptions with regard to future cash flows and the appropriate discount rate. A change in any of the significant assumptions or estimates used to evaluate customer relations could result in a material change to the results of operations.

iii. Percentage of completion and revenues from long-term production-type contracts

   Revenues recognized on long-term production-type contracts reflect management's best assessment, by taking into consideration all information available at the reporting date, of the result on each ongoing contract and its estimated costs. The management assesses the profitability of the contract by applying important judgments regarding milestones marked, actual work performed and estimated costs to complete. Actual results could differ because of these unforeseen changes in the ongoing contracts' models.

5. Business acquisition

a) Transaction for the year ended December 31, 2011

On July 1, 2011, the Company acquired an additional 16.49% of the outstanding shares of Xebec Adsorption South East Asia PTE. Ltd. Accordingly, the Company now owns 56.49% of the outstanding shares and acquired control of the joint venture. The acquisition was settled by the conversion of its loan that it had previously made to the joint venture. The acquisition was accounted for under the purchase method, and the full operating results of the subsidiary are included in the consolidated financial statements from the acquisition date.

The fair value of the net assets acquired is attributed as follows:

	$
Assets acquired:	
Cash	78,443
Accounts receivable	320,174
Inventories	26,971
Prepaid expenses	3,046
Property, plant and equipment	15,411
	444,045
Liabilities assumed:	
Accounts payable and accrued liabilities	178,179
Deferred revenues	229,086
Provision	1,925
	409,190
Net assets acquired at fair value	34,855
Net assets attributable to non-controlling interest	15,166
Net assets attributable to initial investment held before acquisition	13,942
Consideration paid in form of conversion of loan	5,747
Total consideration deemed paid	34,855

6. Gain on disposition of assets

On March 22, 2012, the Company sold to Air Products and Chemicals Inc. (“Air Products”) its intellectual property (“IP”) portfolio, including the patents and patent applications relating to its gas separation technology. In this transaction, the Company has also transferred ownership of its research and development facilities in Burnaby and Surrey, as well as other equipment located in British Columbia.

Pursuant to this transaction, the Company has received aggregate gross proceeds of $8,600,000 and net proceeds of approximately $8,415,000. This agreement also foresees future proceeds related to the achievement of certain conditions to be met by Xebec within the next 24 months. With the net proceeds received, the Company reimbursed its bank loan of $500,000 and its subordinated loan of $83,700.

On October 23, 2012, the Company received additional gross proceeds of $1,000,000 in relation to the achievement of certain conditions.

The Company has also entered into a perpetual license agreement with Air Products with no additional costs allowing it to continue using the gas separation technology to sell its systems, predominantly in the biogas, natural gas and associated gas purification markets.

The Company has utilized its non-capital losses carried forward to offset the taxable gain resulting from this sale (see note 22).

The following table summarizes the gain on disposition of assets:

	March 22, 2012 $
Gross proceeds	8,600,000
Additional proceeds	1,000,000
Transaction fees	(185,481)
Net proceeds	9,414,519
Goodwill allocated to the disposition	(200,000)
Carrying value of assets	(2,918,037)
Others	149,479
Gain on disposition of assets	6,445,961

7 Trade and other receivables

	December 31, 2012 $	**December 31, 2011 $**
Trade receivables	3,154,623	2,009,939
Unbilled receivable	209,012	162,697
Other receivables	805,327	466,479
Less: Allowance for doubtful accounts	(232,216)	(194,273)
Trade receivables - net	3,936,746	2,444,842

Trades receivables include holdbacks amounting to $183,887 for the year ended December 31, 2012 (2011 -$202,995).

Trade receivables are pledged as security for the credit facilities (see note 11, Bank loan).

8 Inventories

	December 31, 2012 $	**December 31, 2011 $**
Raw materials	1,188,653	1,006,247
Work in progress	361,898	330,355
Finished goods	111,943	28,658
Inventories	1,662,494	1,365,260

Cost of goods sold includes cost of inventories amounting to $7,019,549 in 2012 (2011 - $5,289,956). Cost of goods sold includes an amount of nil (2011 – $11,698) and $103,987 in selling and administrative expenses (2011 – $366,314) for the writedown of inventories to the lower of cost and net realizable value.

Work-in-progress inventories are pledged as security for the credit facilities (see note 11, Bank loan).

9 Property, plant and equipment

	Machinery and equipment $	Office furniture and equipment $	Computers $	Moulds $	Vehicles $	Leasehold improvements $	Total $
Cost							
Balance at December 31, 2011	742,821	107,230	338,157	67,648	71,968	663,023	1,990,847
Additions	68,738	3,878	45,004	15,485	-	-	133,105
Disposals	(363,788)	(11,911)	(155,863)	-	(35,984)	(646,301)	(1,213,847)
Effect of movements in exchange rates	(1,033)	(237)	(582)	(766)	-	(7,180)	(9,798)
Balance at December 31, 2012	446,738	98,960	226,716	82,367	35,984	9,542	900,307
Accumulated amortization							
Balance at December 31, 2011	445,861	71,076	324,639	38,897	21,590	540,113	1,442,176
Amortization	53,578	19,050	16,912	13,426	13,194	26,492	142,652
Disposal	(312,993)	(10,641)	(155,863)	-	(16,792)	(549,881)	(1,046,170)
Effect of movements in exchange rates	(397)	(49)	(353)	(346)	-	(7,182)	(8,327)
Balance at December 31, 2012	186,049	79,436	185,335	51,977	17,992	9,542	530,331
Carrying Amount							
At December 31, 2011	296,960	36,154	13,518	28,751	50,378	122,910	548,671
At December 31, 2012	260,689	19,524	41,381	30,390	17,992	-	369,976

10 Intangible assets and goodwill

			Other	Internally generated		
	Patents $	**Customer relations** $	**Software** $	**Engineering drawings** $	**Total intangible assets** $	**Goodwill** $
Cost						
Balance at December 31, 2011	3,315,985	1,900,000	214,074	4,700	5,434,759	342,616
Disposals	(3,368,662)	-	-	-	(3,368,662)	(200,000)
Additions	52,677	-	32,294	-	84,971	-
Effect of movements in exchange rates	-	-	(795)	-	(795)	-
Balance at December 31, 2012	-	1,900,000	245,573	4,700	2,150,273	142,616
Accumulated amortization						
Balance at December 31, 2011	549,835	678,572	213,335	4,700	1,446,442	-
Amortization of the year	49,275	271,428	4,916	-	325,619	-
Accumulated depreciation of assets disposed	(599,110)	-	-	-	(599,110)	-
Effect of movements in exchange rates	-	-	(936)	-	(936)	-
Balance at December 31, 2012	-	950,000	217,315	4,700	1,172,015	-
Carrying Amount						
At December 31, 2011	2,766,150	1,221,428	739	-	3,988,317	342,616
At December 31, 2012	-	950,000	28,258	-	978,258	142,616

Amortization of $325,619 (2011 - $512,597) is included in the consolidated statement of loss: $50,357 (2011 - $231,334) in “cost of goods sold” and $275,262 (2011 - $281,263) in “selling and administrative expenses”.

As at December 31, 2012, management determined that an indicator of impairment existed for the customer relations while comparing its financial forecasts to prior period forecasts and considering other market factors and indicators. The recoverable amount of the customer relations has been determined based on a value-in-use calculation using cash flow projections from financial budgets approved by senior management covering a six-year period. The pre-tax discount rate applied to cash flow projections is 15%. As a result of this analysis, management determined that no impairment charge was required.

11 Bank loan

As at December 31, 2012, the Company had a revolving demand facility by way of letters of credit and letters of guarantee amounting to $1,000,000 with Royal Bank of Canada which bore interest at the Royal Bank's prime rate plus 2.50% per annum and which were limited by certain margin requirements concerning accounts receivable.

In addition, the Company had access to credit facilities in the amount of $500,000 with Royal Bank of Canada which were guaranteed by Export Development of Canada and bore interest at the Royal Bank's prime rate plus 2.5% per annum and were limited by certain requirements concerning pre-shipment costs. These credit facilities were used up to $166,952 as at December 31, 2012.

The bank loan is secured by a first ranking hypothec of $4,000,000 on all movable property of the Company and is renewable annually.

12 Trade and other payables

	December 31, 2012 $	December 31, 2011 $
Trade payables	3,472,289	4,516,080
Payables to related parties (note 25)	8,574	31,435
Other payable	318,628	-
Trade and other payables	3,799,491	4,547,515

13 Deferred revenues

	December 31, 2012 $	December 31, 2011 $
Deferred revenue from long-term contracts	684,344	1,816,275
Deferred revenue other contracts	383,643	690,199
Deferred revenue	1,067,987	2,506,474

Revenue recognized for long-term contracts amounted to $7,791,344 for the year ended December 31, 2012 (2011 - $4,369,730). Costs incurred for long-term contracts in progress as at December 31, 2012 amounted to $2,833,296 for a profit of $767,335 (2011 – costs of $1,667,986 and $226,516 respectively).

14 Provisions

	Restructuring costs $	Anticipated loss on long-term contract $	Warranty costs $	Total provision $
At December 31, 2011	61,000	95,000	299,718	455,718
Additional provisions	-	-	258,054	258,054
Unused amount reversed	-	(18,813)	(11,292)	(30,105)
Used during year	(61,000)	(76,187)	(58,480)	(195,667)
At December 31, 2012	-	-	488,000	488,000

(a) Restructuring costs

A provision of $61,000 related to the termination benefits of one employee has been paid during 2012.

(b) Warranty costs

The Company offers warranties 18 months after shipping or 12 months after start-up to the purchasers of its gas purification and natural gas dryers.

15 Long-term debt

a) Loans

	2012 $	2011 $
Loan from Canada Economic Development for a maximum of $99,994 (2011 - $133,318), matures December 2015, bears no interest and is repayable in monthly instalments of $2,777	99,994	133,318
Loan from Canada Economic Development for a maximum of $62,500 (2011 - $87,500), matures January 2015, bears no interest and is repayable in eight semi-annual instalments of $12,500	62,500	87,500
Term finance contract, matures June 2015, bears annual interest of 5.99% and is secured by a lien on a vehicle (net book value of $17,992). Repayable in monthly instalments of $785 including capital and interest	21,822	58,729
Loan from Investissement Québec, bears annual interest at the lender's floating rate plus 2%, paid during the year	-	98,968
Term finance contracts, mature December 2013, and are secured by a lien on equipment (net book value of $9,807). It is repayable in monthly instalments of $831 including capital and interest	9,807	-
	194,123	378,515
Less: Current portion	76,474	141,786
	117,649	236,729

b) Disposition of building and land:

On September 30, 2011, the Company sold and leased back its building. With the proceeds, the Company repaid its mortgages and used the remainder to fund its working capital. There is also a balance of sale of $800,000 that will become available to the Company consisting of an amount of $200,000 on the second anniversary date of the sale and $600,000 on the fourth anniversary date of the sale. The balance of sale bears interest at four percent and the interest is receivable on each anniversary date of the sale. The balance of sale has since been renegotiated (note 29a)).

c) Government royalty program obligations:

The Company signed a settlement agreement with Technology Partnership Canada ("TPC") with regard to its Fast Cycle Pressure Swing Adsorption and Gas Management systems and Pulsar Pressure Swing Adsorption project. The Company had to pay $250,000 at the execution of the agreement and $1,000,000 spread over four equal annual non-interest bearing payments, starting on January 31, 2013 (note 29b)). Furthermore, the Company is liable to pay up to $750,000 in contingent payments based on proceeds from the sale by the Company of its intellectual property. Upon closing of the transaction (see note 6), the Company paid $540,000 out of the $750,000 total contingent-based payments. On October 23, 2012, the Company accrued another $150,000 out of the $750,000 total contingent based payments, following additional proceeds received (see note 6), leaving a potential maximum amount to be paid of $60,000 as at December 31, 2012.

The following table summarizes the activity related to the government royalty program obligation during the period:

	2012	**2011**
	$	**$**
Balance - Beginning of year	948,921	691,539
Accretion interests	89,611	257,382
Additional contingent debt	150,000	-
Loss on debt settlement	682,280	-
Repayment	(790,000)	-
Balance - End of year	1,080,812	948,921
Current portion	(365,959)	(195,949)
	714,853	752,972

The settlement agreement was accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability as the terms and conditions are substantially different. The Company recorded a loss on debt settlement of $682,280 in the consolidated statement of earnings (see note 20).

The carrying amount of the government royalty program obligation has been calculated by discounting the future cash flows at the interest rate of five percent.

Prior to this settlement agreement, the Company had an agreement with Industry Canada under the TPC Program to receive financial contributions regarding the development and commercial exploitation of its Fast Cycle Pressure Swing Adsorption ("FCPSA"), Gas Management Systems ("GMS") and Pulsar Pressure Swing Adsorption project ("PSA").

Pursuant to the FCPSA and GMS agreement, total project costs for the period from October 1, 2002 to September 30, 2008 were to be shared, subject to certain contribution limits, such that the Ministry's contribution would not exceed the lesser of 30% of eligible project costs and $8,139,937. The agreement further provided that the contributions were repayable on a royalty of 0.471% of gross business revenues during the royalty period.

Pursuant to the PSA 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 Ministry's contribution would not exceed the lesser of 35% of eligible project costs and $4,947,330. The Company had received contributions aggregating $4,762,503. The agreement further provided that the contributions were repayable based on a royalty of 1.8% of gross project revenues and revenues from fuel-cell related products during the royalty period to a maximum cumulative repayment of $8,750,000.

16 Share capital

a) The Company is incorporated under the Canada Business Corporations Act and its authorized share capital consists of an unlimited number of common and preferred shares, without par value.

b) Share purchase warrants

Information that summarizes the activity related to the Company's share purchase warrants for the year ended December 31, 2012:

	Number of warrants	2012 Weighted average exercise price $	Number of warrants	2011 Weighted average exercise price $
Balance – Beginning of year	10,658,136	0.45	15,456,424	0.64
Granted	-	-	-	-
Exercised	-	-	-	-
Expired	(566,250)	0.40	(4,798,288)	1.07
Balance – End of year	10,091,886	0.45	10,658,136	0.45

The following table summarizes the share purchase warrants outstanding as at December 31, 2012, all of which are exercisable:

	Warrants outstanding		
Exercise price $	Number of warrants outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price $
0.45	10,091,886	2.84	0.45
	10,091,886	2.84	0.45

c) Earnings (loss) per share

i. Basic

Basic loss per share is calculated by dividing the net income attributable to owners of the parent by the weighted average number of common shares in issue during the year.

	For the year ended December 31, 2012 $	**For the year ended December 31, 2011 $**
Net income (loss) attributable to owners of the parent	1,682,927	(1,447,123)
Weighted average number of common shares in issue	39,363,867	39,363,867
	$0.04	($0.04)

ii. Diluted

Diluted earnings per share is calculated by adjusting the weighted average number of common shares outstanding to assume conversion of all dilutive potential common shares. The Company has two categories of dilutive potential common shares: warrants and stock options. For both, a calculation is performed to determine the number of shares that could have been acquired at fair value (determined as the average market share price of the Company's outstanding shares for the period), based on the monetary value of the subscription rights attached to the warrants and stock options. The number of shares calculated below is compared with the number of shares that would have been issued assuming exercise of the warrants and stock options. For the year ended December 31, 2011, the diluted net loss per share was the same as the basic net loss per share, since the effect of assumed exercise of share options and warrants to purchase common shares was anti-dilutive.

	For the year ended December 31, 2012 **$**	**For the year ended December 31, 2011** **$**
Net income (loss) attributable to owners of the parent	1,682,927	(1,447,123)
Weighted average number of common shares in issue	39,363,867	39,363,867
Dilutive effect of stock options	3,169,961	-
Diluted weighted average number of shares	42,533,828	39,363,867
	$0.04	($0.04)
Items excluded from the calculation of diluted net income (loss) per share because the exercise price was greater than the average market price of the common shares or due to their anti-dilutive effect		
Stock options	21,538	2,454,789
Warrants (number of equivalent shares)	4,541,349	4,767,849

17 Stock options

The stock option plan (the "Plan") allows for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards and other stock-based awards. Under the Plan, common shares approved for issuance under all stock-based compensation arrangements are limited to the greater of 591,560 and 10% of the common shares issued and outstanding. As at December 31, 2012, the maximum number of common shares available for issuance under all stock-based compensation arrangements is 3,936,387.

Under the terms of the Plan, stock options are granted with an exercise price not less than the volume-weighted average trading price of the common shares for the five trading days prior to the date of grant. The terms and conditions for acquiring and exercising options are set by the Board of Directors. Stock options for employees vest no less than at grant date and no more than quarterly. The vesting right acquisitions are gradual and equal over two years for the 2012 grants except for 460,000 stock options which vested at the grant date (2011 - 2,215,544) and over four years for previous grants and are exercisable for seven years from the date of grant. Stock options for directors vest at the grant date and are exercisable for seven years from the grant date.

Stock option activity for the years ended December 31 is presented below:

	2012		2011	
	Number of options	**Weighted average exercise price $**	**Number of options**	**Weighted average exercise price $**
Outstanding – Beginning of year	3,426,123	0.26	107,361	5.99
Granted	460,000	0.15	3,465,544	0.15
Forfeited	(455,666)	0.67	(146,782)	1.78
Expired	-	-	-	-
Outstanding – End of year	3,430,457	0.19	3,426,123	0.26
Exercisable – End of year	3,191,499	0.19	2,454,789	0.27

As at December 31, 2012, options outstanding in the Plan and options exercisable are as follows:

					2012
	Options outstanding			Options exercisable	
Exercise price range $	**Number of options**	**Weighted average remaining contractual life (years)**	**Weighted average exercise price $**	**Number of options**	**Weighted average exercise price $**
0.10 - 0.20	2,620,000	6.00	0.11	2,620,000	0.11
0.22 - 0.27	788,919	5.57	0.24	549,961	0.24
0.44 - 1.50	6,100	1.36	1.09	6,100	1.09
9.00 - 13.90	15,263	3.70	11.95	15,263	11.95
16.20 - 17.50	175	2.00	17.00	175	17.00
	3,430,457	2.06	0.19	3,191,499	0.19

The fair value of the options granted has been estimated according to the Black-Scholes option pricing model and based on the weighted average of the following assumptions for options granted during the year:

		2012		2011
	Non-employees	Employees	Non-employees	Employees
Dividend yield	0%	0%	0%	0%
Exercise price	$ 0.10	$ 0.20	$ 0.14	$ 0.15
Risk-free interest rate	0.90%	1.20%	0.91%	0.98%
Estimated life	2.00	2.00	2.00	2.00
Expected volatility	81%	81%	81%	81%
Stock price	$ 0.09	$ 0.22	$ 0.13	$ 0.14

The weighted average fair value of the options granted to employees during the year is $0.10 (2011 $0.14) and $0.04 (2011 $0.13) for the options granted to non-employees.

Compensation expenses with respect to these options amounted to $70,264 for employees and $8,117 for non-employees for the year ended December 31, 2012 (2011 – $127,741 and $37,122).

18 Expenses by nature

	2012 $	2011 $
Material	7,020,136	5,350,771
Employee salaries and benefits	6,558,487	6,631,496
Rent and repairs and maintenance	907,813	811,444
Professional fees	779,412	1,096,386
Subcontracting costs	751,748	479,178
Travel expenses	744,817	537,744
Office expense	671,950	549,180
Amortization	468,272	897,671
Other	463,358	326,905
Commission	89,502	-
Stock-based compensation	78,381	164,863
	18,533,876	16,845,638

19 Research and development expenses

	2012 $	2011 $
Research and development expenses	147,585	627,672
Government grants	(5,000)	(5,000)
Research and development tax credits	-	(72,327)
	142,585	550,345

20 Finance expenses

	2012 $	2011 $
Interest and bank charges	56,176	64,651
Interest on bank loan	25	34,744
Interest on long-term debt and subordinated loan	4,308	109,789
Interest charges	26,903	51,311
Accretion and revaluation of government royalty program obligation (see note 15c))	921,891	257,382
	1,009,303	517,877

21 Compensation of key management

Compensation awarded to key management included:

	2012 $	2011 $
Salaries and short-term employee benefits	676,301	1,005,980
Stock-based compensation	54,230	96,721
	730,531	1,102,701

Key management included the Company’s senior management and members of the Board of Directors.

22 Income taxes

a) Income tax expense

Income taxes included in the consolidated statements of earnings (loss) are as follows:

	2012 $	**2011 $**
Current	-	-
Deferred	-	-
	-	-

b) Effective tax rate

The Company's effective income tax rate differs from the statutory federal and provincial income tax rate in Canada. This difference arises from the following:

	2012 %	**2011 %**
Combined statutory rate applied to pre-tax loss	26.59	27.90
Non-deductible items	2.90	(14.73)
Non-taxable portion of gain on disposal of assets	(51.63)	42.29
Net change in unrecognized deferred income tax assets	14.92	(38.71)
Impact of changes in income tax rates on deferred income taxes	8.02	(18.56)
Other	(0.80)	(1.81)
Effective income tax rate	-	-

The applicable statutory tax rates are 26.59% in 2012 and 27.90% in 2011. The Company's applicable tax rate is the Canadian combined rates applicable in the jurisdictions in which the Company operates. The decrease is mainly due to the reduction of the federal income tax rate in 2012 from 16.5% to 15%.

c) Deferred income tax assets and liabilities

	2012 $	2011 $
Deferred income tax assets		
Property, plant and equipment	176,874	452,785
Net operating losses carried forward	14,850,513	15,173,061
Financing costs	92,860	146,356
Intangible assets	-	147,595
Scientific research and development expenses	6,264,483	6,329,223
Investment tax credits	3,847,117	5,917,676
Other	104,433	111,206
	25,336,280	28,277,902
Deferred income tax liabilities		
Intangible assets	(258,440)	-
	25,077,840	28,277,902
Unrecognized deferred income tax assets	(25,077,840)	(28,277,902)
Net deferred income tax assets (liabilities)	-	-

In assessing the realizability of deferred income tax assets, management considers whether it is probable that some portion or all of the deferred income tax assets will be realized. The ultimate realization of deferred income tax assets is dependent on 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 deferred income tax assets, these deferred income tax assets have not been recognized.

Most of these unrecognized deferred income tax assets relate to QuestAir's deferred income tax asset balance at the acquisition date. When a deferred income tax asset acquired in a business combination is not recognized at the date of acquisition, any subsequent recognition of the tax benefit will reduce income tax expense, resulting in an increase in net earnings.

d) Other

The Company has non-capital losses carried forward in Canada of approximately $55,800,000 (2011 - 57,400,000) which are available to reduce taxable income in future years, the benefit of which has not been recorded in the accounts, and which expire as follows:

	$
2014	2,800,000
2025	6,900,000
2026	7,200,000
2027	6,800,000
2028	10,800,000
2029	7,200,000
2030	12,400,000
2031	700,000
2032	1,000,000
	55,800,000

The Company has scientific research and experimental development expenses of approximately $23,500,000 which are available to be carried forward indefinitely and deducted against future taxable income otherwise calculated.

As at December 31, 2012, the Company also has investment tax credits of approximately $5,244,000 available to offset future Canadian federal income taxes payable. The potential benefit of the investment tax credits has not been recognized in the accounts and expires as follows:

	$
2016	10,000
2017	30,000
2018	100,000
2019	470,000
2020	910,000
2021	240,000
2022	920,000
2023	480,000
2024	740,000
2025	650,000
2026	410,000
2027	240,000
2029	32,000
2032	12,000
	5,244,000

23 Commitments

Following is a summary of Xebec's contractual obligations and commitments:

As at December 31, 2012	Payment Due by Period			
	1 year	2 - 5 years	Beyond 5 years	Total
	$	$	$	$
Operating leases[1]	669,644	1,445,887	2,853,225	4,968,756

As at December 31, 2011	Payment Due by Period			
	1 year	2 - 5 years	Beyond 5 years	Total
	$	$	$	$
Operating leases[1]	826,736	1,855,211	3,163,416	5,845,363

(1) Operating leases include one building in Blainville (2011 – two buildings in Vancouver and one in Blainville) and various equipment leases.

24 Contingent liabilities

The Company is party to various ongoing and pending litigation along with other contingencies arising out of normal course of business. Management believes that these claims, when resolved, will not have any material adverse effect on the consolidated financial position or results of operations of the Company.

25 Related party transactions

The following table presents a summary of the related party transactions during the year:

	2012	**2011**
	$	**$**
Marketing and professional service expenses paid to companies controlled by members of the immediate family of an officer	73,408	46,355
Sales to an entity controlled by a Company director	24,324	74,372
Loan from a Company director	-	23,562
Repayment of loan from a Company director	24,123	-
Accrued interest on a loan from a Company director	1,841	315

These transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

26 Capital management

The Company's objective when managing capital is to use short-term funding sources to manage its working capital requirements and fund capital expenditures required to execute its operating and strategic plans.

The Company's capital structure is composed of the following:

	2012 $	2011 $
Cash	1,344,114	389,090
Bank loan	(166,952)	(500,000)
Long-term debt	(194,123)	(378,515)
Government royalty program obligation (note 15c))	(1,080,812)	-
	(97,773)	(489,425)
Equity (Deficiency)	1,737,339	(307,121)
	1,639,566	(796,546)

The Company is not subject to any capital requirements imposed by regulators.

27 Segmented information

The Company has only one segment and specializes in the design and manufacture of filtration, purification, separation and dehydration equipment for gases and compressed air. The Company has five product lines and provides related engineering services.

Revenue summarized by country, as determined by location of the customers, is as follows:

	2012 $	2011 $
Revenue		
Canada	3,524,821	1,819,934
India	2,513,898	21,062
South Korea	2,256,855	251,742
United States	2,207,137	8,355,044
Republic of China	2,160,933	1,246,519
Other	2,515,477	2,509,162
	15,179,121	14,203,463

Revenue summarized by product line is as follows:

	2012 $	2011 $
Product line		
Gas purification	8,169,548	4,876,066
Natural gas dryers	4,338,956	4,459,762
Compressed gas filtration	2,092,661	1,558,387
Engineering services	427,192	1,665,589
Air dryers	121,474	178,772
Associated gas	29,290	-
Licensing	-	1,464,887
	15,179,121	14,203,463

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

	2012 $	2011 $
Customer A	2,256,275	21,062
Customer B	1,555,342	352,146
	3,811,617	373,208

The location of the Company's non-current assets by geographic region is as follows:

	2012 $	2011 $
Non-current assets		
Canada	1,982,855	5,563,424
Asia	107,995	116,180
	2,090,850	5,679,604

28 Financial instruments

(a) Measurement categories and fair values, including valuation methods and assumptions

The following table shows the carrying values and the fair values of assets and liabilities for each of these categories as at December 31, 2012 and 2011:

December 31, 2012	Loans and receivables		Other financial liabilities	
	Carrying amount $	Fair value $	Carrying amount $	Fair value $
Cash	1,344,114	1,344,114	-	-
Trade and other receivables	3,936,746	3,936,746	-	-
Bank loan	-	-	166,952	166,952
Trade payables	-	-	3,799,491	3,799,491
Accrued liabilities	-	-	1,144,539	1,144,539
Long-term debt	-	-	194,123	183,979
Government royalty program obligation	-	-	1,080,812	1,036,488

December 31, 2011	Loans and receivables		Other financial liabilities	
	Carrying amount $	Fair value $	Carrying amount $	Fair value $
Cash	389,090	389,090	-	-
Trade and other receivables	2,444,842	2,444,842	-	-
Bank loan	-	-	500,000	500,000
Trade payables	-	-	4,547,515	4,547,515
Accrued liabilities	-	-	1,195,825	1,195,825
Long-term debt	-	-	279,547	279,547
Government royalty program obligation	-	-	948,921	948,921
Subordinated loan	-	-	98,968	98,968
Loan from a related party	-	-	23,562	23,562

The carrying values of cash, trade and other receivables, trade payables and accrued liabilities and bank loan approximate their fair value due to their short-term maturities. The methods and assumptions used in estimating the fair values of other financial assets and financial liabilities are as follows:

- Loan to a joint venture: Fair value of the loan has been calculated by discounting the loan on a one-year period to the interest rate of a similar investment.

- Long-term debt and subordinated loan: The Company's long-term debt and subordinated loan carry fixed interest rates. The fair value of the Company's debt obligations and subordinated loan has been calculated by discounting the future cash flows of the respective long-term debt and subordinated loan at the interest rate of similar debt instruments.

- Government royalty program obligation: Fair value of the government royalty program obligation has been calculated by discounting the future cash flows at the interest rate for a similar loan in the market.

(b) Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party fails to meet its contractual obligations. The Company's primary credit risk is its cash and outstanding trade accounts receivable. The carrying amount of its outstanding trade accounts receivable represents the Company's estimate of its maximum credit exposure. The Company regularly monitors its credit risk exposure and takes steps such as employing credit approval procedures, establishing credit limits, using credit assessments and monitoring practices to mitigate the likelihood of these exposures from resulting in an actual loss. An allowance for doubtful accounts amounting to $232,216 (2011 – $194,273) was established based on prior experience and an assessment of current financial conditions of customers as well as the general economic environment. In the case where an allowance for doubtful accounts provision is recorded and a receivable balance is considered uncollectible, it is written off against the allowances for doubtful accounts. Bad debt expense amounted to $50,375 in 2012 (2011 – $138,348). As at December 31, 2012, the Company's three largest trade debtors accounted for 36% (16%, 13% and 7%) of the total accounts receivable balance (2011 – 28% (11%, 9% and 8%)).

Details of accounts receivable were as follows:

	December 31, 2012 $	December 31, 2011 $
Current trade receivables	669,381	247,964
Trade receivables past due by:		
1–30 days	361,223	304,949
31–60 days	376,467	111,037
61–90 days	561,400	122,177
Over 90 days	1,186,152	1,223,812
Total trade receivables	3,154,623	2,009,939
Allowances for doubtful accounts	(232,216)	(194,273)
Other receivables	1,014,339	629,176
Total accounts receivable	3,936,746	2,444,842

The following table summarizes the changes in the allowance for doubtful accounts for trade receivables:

At December 31, 2011	(194,273)
Provision for impairment	(50,375)
Receivables written off during the year as uncollectible	12,432
Unused amounts reversed	-
At December 31, 2012	(232,216)

The Company's cash is maintained at financial institutions with high credit ratings; therefore, the Company considers the risk of non-performance on these instruments to be remote. To date, the Company has not incurred any losses related to these instruments.

(c) Market risk

(i) Currency risk

Certain financial assets and financial liabilities are exposed to foreign exchange fluctuations. Taking into account the amounts denominated in the currencies indicated below and assuming that all of the other variables remain unchanged, a fluctuation in exchanges rates would have an impact on the Company's net loss. Management believes that a 10% change in exchange rates would be reasonably possible and that the impact on the net loss of such a change would be approximately $(46,846) for 2012 (2011 $(9,160)). As at December 31, 2012, the following amounts are shown in their original currencies but converted into Canadian dollars. The Company does not use financial instruments to reduce this risk.

				2012
	Thai baht	**US dollar**	**Euro**	**British pound sterling**
Cash	-	165,154	4,291	-
Accounts receivable	15,661,786	1,078,533	60,990	-
Accounts payable and accrued liabilities	-	(268,949)	(164,810)	-
	15,661,786	974,738	(99,529)	-
Equivalent in Canadian dollars	509,321	969,767	(130,563)	-

	2011			
	Thai baht	**US dollar**	**Euro**	**British pound sterling**
Cash	-	50,828	1,630	-
Accounts receivable	-	1,734,397	2,991	-
Accounts payable and accrued liabilities	-	(961,399)	(66,486)	(6,142)
	-	823,826	(61,865)	(6,142)
Equivalent in Canadian dollars	-	837,831	(81,617)	(9,704)

(ii) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of financial instruments will fluctuate as market interest rates change.

The Company is exposed to interest rate risk on its bank loan and long-term debt, for which the interest rates charged fluctuate based on the bank prime rate. As at December 31, 2012, the short-term bank loan amounted to $166,952 (2011 – $598,968). If the interest rate on the bank debt had been 50 basis points higher (lower), related to the bank loan as at December 31, 2012, net loss would have been $417 (2011 – $2,995) higher (lower).

(d) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due.

The following are the contractual maturities of financial liabilities as at December 31:

	2012				
	Carrying amount $	**Contractual cash flow $**	**0 to 12 months $**	**13 to 24 months $**	**Thereafter $**
Financial liabilities					
Bank loan	166,952	166,952	166,952	-	-
Accounts payable	3,799,491	3,799,491	3,799,491	-	-
Accrued liabilities	1,144,539	1,144,539	1,144,539	-	-
Government royalty program obligation	1,080,812	1,150,000	400,000	250,000	500,000
Long-term debt	194,123	196,012	77,711	67,745	50,556
	6,385,917	6,456,994	5,588,693	317,745	550,556

					2011
	Carrying amount $	**Contractual cash flow $**	**0 to 12 months $**	**13 to 24 months $**	**Thereafter $**
Financial liabilities					
Bank loan	500,000	500,000	500,000	-	-
Accounts payable	4,547,515	4,547,515	4,547,515	-	-
Accrued liabilities	1,195,825	1,195,825	1,195,825	-	-
Loan from a related party	23,562	23,562	23,562	-	-
Government royalty program obligation	948,921	11,376,701	313,852	134,331	10,928,518
Long-term debt and subordinated loan	378,515	379,721	139,667	108,419	131,635
	7,594,338	18,023,324	6,720,421	242,750	11,060,153

Contractual interest amounts that are on floating interest rates are established based on the spot rates as at the respective balance sheet dates.

The Company’s development is financed through a combination of borrowing under the existing credit facilities, the issuance of debt and the issuance of equity (note 1).

29 Subsequent events

a) On January 30, 2013, the Company renegotiated the balance of sale of $800,000 receivable pursuant to the sale and lease back of its building. It is now consisting of an amount of $300,000 paid on March 1, 2013, and $300,000 to be paid on March 1, 2014 and $200,000 to be paid on March 1, 2015. The balance of sale bears interest at four percent and the interest is receivable on each anniversary date of the sale.

b) On February 1, 2013, the Company became in default with regard to its TPC agreement. The Company negotiated and obtained a four-month extension to repay its annual payment (note 15c)).