

**QuestAir Technologies Inc.**

**Annual Report  
For the Year Ended September 30, 2008**

Additional information relating to the Company, including a copy of the Company's Annual Information Form, can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

## **President's Message**

2008 was a transformational year for QuestAir. We expanded our reach into the biogas market while significantly improving our financial results over fiscal 2007, with a 63% increase in revenue to \$11.4 million and a 33% reduction in cash burn to \$7.1 million for fiscal 2008.

The dramatic reduction in cash usage in the second half of the fiscal year confirmed that the measures we undertook at mid-year to reduce our operating expenses had an immediate, decisive effect. We ended the year with a cash balance of \$9.6 million, providing us with growth capital that will allow us to weather the economic crisis that has unfolded over the past few months.

The gains we made in fiscal 2008 were achieved in a challenging business environment that included an extremely strong Canadian dollar, tightening credit conditions and delays in European subsidies for the biogas upgrading industry.

## **Strong progress in the biogas market**

We made substantial headway in the biogas market during the year, signing supply and distribution agreements with two of our repeat customers - Phase 3 Developments and Investments LLC in the United States and Verdesis Suisse SA in Europe. These partners are strong supporters of QuestAir's products, having integrated our pressure swing adsorption ("PSA") systems into their biogas upgrading plants. In April 2008, we announced an order from Phase 3 to provide an M-3200 PSA system to the Hilarides Dairy in Lindsay, California. The PSA unit will be integrated into a commercial scale plant designed to generate renewable compressed natural gas ("CNG") vehicle fuel from agricultural waste.

Also during the year, we received two new orders from Verdesis for M-3200 methane purification systems to be installed in Europe. Both systems will purify methane generated from anaerobic digestion of organic waste.

In 2008 we expanded our product offering in the biogas market to include integrated upgrading plants that incorporate all the equipment necessary to produce compressed, purified renewable natural gas from raw biogas. In addition, we plan to offer value-added services including plant operating contracts and maintenance contracts. By expanding our product and services offering in the biogas market, we expect to increase the size of our addressable market and create sustained recurring revenue streams from each upgrading plant that we sell.

In July 2008, the British Columbia Government announced funding for several clean energy projects through the Innovative Clean Energy ("ICE") Fund. We expect to supply biogas upgrading plants for two of these projects, including a \$1.1 million biogas upgrading project at the Lions Gate Wastewater Treatment Plant in West Vancouver. This project will recover and upgrade biogas generated from the digestion of municipal sewage. We are working with Terasen Gas, the principle natural gas distributor in the province of B.C., and Metro Vancouver, the owner of the waste water treatment facility, on this project. It is expected to supply renewable energy to heat approximately 100 homes.

In September 2008, we signed a Memorandum of Understanding with Terasen Gas to work jointly on the development of projects to produce supplies of biomethane from organic waste. Renewable natural gas generated from these projects would be injected into the existing pipeline system operated by Terasen Gas for distribution to homes and businesses.

In the hydrogen purification market, we secured a number of orders for H-3200 PSA systems, including the sale of two systems for hydrogen plants in Mexico and Russia and three hydrogen PSA units to Iwatani for the Japanese market. However, we did not achieve our objective of growing the hydrogen PSA business in fiscal 2008.

In the refinery hydrogen market, we achieved a substantial technical success with the completion of the field test of the H-6200 hydrogen purifier at an ExxonMobil affiliate refinery in France. However, our marketing efforts in the refinery market were impacted by the recent drop in oil prices and delays in certain target customer projects, affecting our near-term H-6200 sales prospects. During 2008 we also announced a new engineering service contract with ExxonMobil Research and Engineering (“EMRE”) valued at US\$6.35 million, which will allow for the further development and commercialization of QuestAir’s rapid-cycle PSA technology.

### **2009 Outlook and Milestones**

Looking forward to fiscal 2009, we face a challenging near-term economic environment in certain target markets.

In the biogas market, growth prospects in Europe remain strong. Recently introduced subsidies for biogas upgrading projects in Germany are expected to drive significant growth in that market in 2009. In the North American biogas market, the recent fall in natural gas prices from historic highs is expected to have some impact on marginal biogas projects, particularly some single farm projects where the economies of scale are not as strong. We believe that the longer term macro-economic drivers of the biogas market in North America remain strong, and a growing number of gas utilities and governments in North America are actively supporting the development of biogas upgrading projects as a source of renewable natural gas. In addition, the production of renewable CNG vehicle fuel from biogas represents a significant value-added end use of biogas that we expect will drive additional growth in the biogas upgrading market.

In the hydrogen market, we expect that demand for purification solutions in the oil refining and steel manufacturing sectors will decline due to the current economic climate. However, this may mean that capital projects will be scaled back in some cases, resulting in the purchase of smaller capacity hydrogen plants or purification systems – a market where we have a competitive advantage. The economic climate has also affected our business in the refinery hydrogen market. Oil prices have declined significantly from their peak in July 2008. In turn, many oil refineries have delayed capital projects and reduced capital spending. While we believe that the market opportunity for the H-6200 refinery hydrogen purifier remains strong, we expect some delay in the development of additional H-6200 projects. At present, we do not have adequate visibility to forecast an H-6200 sale in fiscal 2009.

### **QuestAir well positioned going forward**

Despite current economic conditions, I am confident that QuestAir is well positioned going forward from a cash, product and strategy standpoint. Fiscal 2009 will be an important year in terms of building out our biogas-focused strategy while ensuring that we continue to serve our core customers in the hydrogen market. Our efforts to grow the biogas business, particularly the emphasis we are placing on expanding our channels to market and selling complete solutions, will not be reflected in our financial results immediately. However, we expect that substantial progress will be made in fiscal 2009 to implement our biogas-focused growth strategy, which will translate into improved financial performance in future years.

Turning to our financial outlook, our strong order backlog as at September 30, 2008 will support forecast revenues in fiscal 2009 in the range of \$10 million to \$12 million, compared to \$11.4 million in fiscal 2008. Our continued focus on prudent cash management and reducing investment in self-funded research and development will deliver further reductions in cash burn in fiscal 2009. We are forecasting cash used in operations and capital expenditures of \$4 million to \$5 million, down from \$7.1 million in fiscal 2008.

In closing, I would like to thank all of our employees for their hard work, dedication and achievements throughout the year. QuestAir's competitive advantage is based largely on the world-leading expertise of our people, and I am grateful to work with such a bright and dedicated group of professionals on a daily basis.

Sincerely,

*(signed)*

Andrew G. Hall  
President & CEO

## **Management Discussion & Analysis for the year ended September 30, 2008**

The following management discussion and analysis (“MD&A”), dated December 3, 2008 (with the exception of the ‘Outstanding Share Data’, which is dated November 30, 2008) should be read in conjunction with the Company’s audited financial statements and related notes therein that are prepared in accordance with Canadian generally accepted accounting principles (“Canadian GAAP”). All financial information is stated in Canadian dollars, unless otherwise indicated. 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](http://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) expectations regarding the Company’s future success in the biogas and other markets; (ii) the key market drivers and other factors that are expected to impact the Company’s performance; (iii) future financial results; (iv) the expected actions of the third parties described herein; (v) the expected use of proceeds from previous financings and other cash resources; and (vi) the business and financial outlook of the Company for fiscal 2009. In addition, this MD&A contains financial outlook information that is intended to provide general guidance for readers based on management’s current estimates, but which is based on numerous assumptions and may prove to be incorrect and therefore such financial outlook information should not be relied upon by readers. 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 statements. These risks include, but are not limited to, risks related to revenue growth, operating results, industry and products, technology, competition, general economic conditions and those factors described in detail herein under the heading ‘Risks & Uncertainties’.

The forward-looking statements contained herein are also based on assumptions that management believes are current and reasonable, including but not limited to, assumptions regarding: (i) trends in certain market segments and the economic climate generally; (ii) the financial strength of our customers; (iii) the value of the Canadian dollar; and (iv) the expected expenses of the Company going forward. The Company cannot assure readers that actual results will be consistent with the statements contained in this MD&A. The forward-looking statements and financial outlook information contained herein are made as of the date of this MD&A and are expressly qualified in their entirety by this cautionary statement. Except to the extent required by law, 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 described herein.

### **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”) systems and integrated gas plants for upgrading biogas to either pipeline or

vehicle-fuel grade renewable natural gas. Biogas is a methane-containing renewable energy source created from organic material in municipal and agricultural waste. Our near-term focus is on smaller capacity systems for single farm anaerobic digesters and smaller landfill gas projects, although we offer a complete range of products up to very large landfill and multi-farm digester projects.

Our strategy to achieve this goal has the following key elements:

1. Expanding our offering over time to include value-added services such as gas plant operating contracts and maintenance contracts to biogas project developers;
2. Leveraging key relationships with leading channel partners and project developers;
3. Investing prudently in product development to enhance the competitiveness of our gas purification products;
4. Marketing our hydrogen PSA systems to existing customers and applications where we have a compelling competitive advantage. This includes the H-6200 refinery hydrogen purifier, which we developed in collaboration with ExxonMobil Research and Engineering (“EMRE”); and
5. Pursuing profitable customer-funded engineering and research and development contracts to enhance QuestAir’s rapid-cycle PSA technology and develop longer term growth opportunities for the Company.

### ***Core Business***

QuestAir is a developer and supplier of advanced gas purification systems. Our products target a range of energy and industrial markets. Our primary focus is in the biogas upgrading market, although we also market PSA systems in the oil refining, industrial hydrogen and natural gas processing markets.

Our compact, modular gas purification products incorporate proprietary PSA technology and offer significant economic and operational benefits over competing gas purification technologies, including reduced capital, installation and operating costs. Our proprietary technology is protected by 57 granted patents covering 27 distinct inventions and 61 pending patent applications covering 12 distinct inventions in the United States, Canada, and certain European, Asian, and other countries.

QuestAir has approximately 50 employees located at our facility and corporate headquarters in Burnaby, Canada. We market and support our products on a global basis from our Burnaby facility.

### ***Products, Markets & Customers***

***Biogas:*** QuestAir’s PSA systems are used to remove impurities such as carbon dioxide and water vapor from biogas, generating pipeline- or compressed natural gas (“CNG”)-grade methane. System integrators such as Phase 3 Renewables LLC (“Phase 3”), Verdesis Suisse SA (“Verdesis”) and SCS Engineers currently integrate QuestAir’s M3100 and M-3200 PSAs into biogas upgrading plants that produce purified renewable natural gas from raw biogas. In fiscal 2008 we signed supply agreements with both Verdesis and Phase 3 to support our growth in both the European and US biogas markets.

In 2008 we expanded our product offering to include integrated upgrading plants that include all the equipment necessary to produce compressed purified renewable natural gas from raw biogas. We are marketing these plants as a turn-key upgrading solution directly to biogas project developers. In addition, we plan to offer value-added services including plant operating contracts and maintenance contracts. By expanding our product and services offering, we expect to increase the size of our addressable market, the

paths to market, and the dollar value of equipment orders, and provide the opportunity to generate recurring revenue streams over the lifetime of the equipment.

In 2008 we signed a Memorandum of Understanding with Terasen Gas (“Terasen”) to support Terasen’s request for expressions of interest (“RFEOI”) in the development of biogas upgrading projects in British Columbia. We expect that our first sales of integrated biogas upgrading plants will include projects arising from Terasen’s RFEOI.

To date we have sold 10 methane PSA systems for integration into biogas upgrading plants in Europe and North America, including two projects that produce renewable CNG vehicle fuel from biogas.

*Industrial Hydrogen:* We also sell our H-3100 and H-3200 range of hydrogen PSAs for use in on-site hydrogen plants, and for recovering hydrogen from various off-gas streams in the petrochemical industry. Since 1997 we have sold more than 100 hydrogen PSA systems to over 45 customers in North America, Latin America, Asia and Europe.

We market and distribute our products directly to customers, and we also have non-exclusive distribution agreements with leading hydrogen plant vendors including Iwatani International and Mitsubishi Kakoki Kaisha. We also have a manufacturing license agreement for our hydrogen purifiers with Hydro-Chem, a leading global supplier of hydrogen plants in the intermediate capacity range.

Our industrial hydrogen PSAs use the same mechanical platform as our biogas PSAs, which allows us to leverage product improvements or new product designs in both markets.

*Hydrogen for Oil Refining:* We have developed proprietary ‘rapid cycle’ PSA technology which we have incorporated into our large capacity H-6200 hydrogen purifier. The H-6200 was developed in collaboration with EMRE for use in a range of potential applications in the oil refining and petrochemical industries. A prototype of the H-6200 hydrogen purifier (the “prototype plant”) was field tested at an ExxonMobil refinery in France in 2008, and has entered commercial service following the successful conclusion of the test. Data from this test will be used to help market this product to other refineries around the world.

The H-6200 offers customers the benefits of a smaller footprint and lower cost relative to competitive products. The product has a skid-mounted, modular design which makes it easy to install and lowers the total erected cost compared to competitive products. Importantly, the H-6200 offers refineries a cost-effective way to increase their available hydrogen by allowing refineries to recover hydrogen from hydrogen-containing waste streams. In addition, the H-6200 hydrogen purifier can be integrated with existing hydrotreating equipment in order to debottleneck production, allowing refineries to process more oil and improve their operational efficiency.

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 roles that each party will play in the marketing process, and how the commercial gain from the sales of the product will be shared between QuestAir and EMRE.

### ***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:



- *Demand for renewable energy:* Environmental concerns regarding global warming and climate change have collectively increased the demand for renewable energy sources such as biogas. Purified or ‘upgraded’ biogas provides natural gas utilities and users with a renewable source of natural gas supply and the ability to reduce the carbon footprint of their supply base.
- *Energy Security:* Concerns regarding energy security in both Europe and North America have prompted the development of domestic (and in many cases renewable) energy sources. Biogas generated from municipal waste at landfills and waste water treatment facilities, or from agricultural waste on farms, is a secure, domestic source of energy.
- *Waste Management:* Animal manure represents a significant source of air emissions (odor and volatile organics) and groundwater contamination in the agricultural sector worldwide. Anaerobic digestion of this waste material generates a more environmentally benign solid that can be spread directly on crop land, with a lower risk of groundwater contamination. This anaerobic digestion process produces raw biogas which is available for upgrading to renewable natural gas.
- *Commodity Prices:* The long-term trend of rising natural gas prices has improved the economics of upgrading biogas to pipeline or vehicle-fuel quality. In the oil refining market, which is significant user of natural gas, rising input prices have focused attention on technologies for increasing the efficiency of the refining processes, and for processing unexploited sources of natural gas.
- *Government incentives and regulations:* Governments have provided direct incentives and/or funding for the development of biogas upgrading projects. In Canada, provincial governments have each introduced financial incentives for biogas upgrading projects in Ontario, Alberta and British Columbia. Likewise, a number of US state governments have introduced renewable energy portfolio standards and have increased the demand for renewable natural gas as a fuel for the centralized generation of renewable electricity. In Europe, the German Government amended its German Renewable Energy (“EEG”) Act in June 2008 to provide direct subsidies for the production of renewable natural gas from biogas. Similarly, in the oil refining market, government regulations mandating reduced sulphur levels in transportation fuels have driven the demand for hydrogen in the oil refining industry to desulphurize crude oil feedstocks.

### ***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 long-term production type contracts and 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<sup>1</sup>. Given the typical lead times of six to 12 months between receipt of an order for a gas purification system and installation and commissioning, recognized revenues 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.

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



- *Cash Burn:* We balance the need to conserve cash in order to limit dilution arising from potential future equity financings with the need to invest in the future growth of our business, which requires investments in research and development, sales and marketing activities and manufacturing capacity. 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 this MD&A.
- *Product Delivery On Time and On Budget:* QuestAir tracks its performance against expected delivery dates and product costs for each PSA unit delivered to customers. On time delivery is a key contributor to customer satisfaction and timely recognition of revenue. Monitoring the costs for each product sold allows us to closely track expected margins to actual and thereby detect costing issues promptly.
- *Progress Against Key Product Development Timelines and Milestones:* The timing and technical progress of our key development programs, including the ongoing engineering service contracts 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.
- *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, 2008, QuestAir had cash resources and short term investments totaling \$9.6 million (including \$0.3 million of restricted cash), in addition to US\$1.8 million available under our credit facilities with Comerica Bank. At the forecast cash burn rate, we have sufficient financial resources to fund our operations for more than 12 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, 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 distribution agreements with Phase 3, Verdesis, Iwatani, Mitsubishi, and Hydro-Chem, while in the oil refining market we have a strong partnership and working relationship with EMRE. We believe that these relationships are a source of competitive advantage for QuestAir.

## **Business Overview**

Fiscal 2008 was in many ways a transformational year for QuestAir.

During the year, we made substantial headway in the biogas market. We signed two supply and distribution agreements in our primary geographic markets: Phase 3 in the United States and Verdesis in Europe. These two companies have been repeat customers and strong supporters of QuestAir's products, having integrated our PSAs into their biogas upgrading plants.

In April 2008, we announced an order from Phase 3 to provide an M-3200 PSA to the Hilarides Dairy in Lindsay, California. Our PSA will be integrated into a plant designed to generate renewable biomethane fuel from agricultural waste. This will be the first commercial scale plant generating transportation fuel from anaerobic digestion of manure in North America.

Also during the year, we received two new orders from Verdesis for methane purification systems to be installed in Europe. Both systems will purify methane generated from anaerobic digestion of organic waste. One installation will be used by a consortium of Swiss farmers while the other will be fed with waste from an industrial application. Verdesis will be providing turn-key plants to both customers, which incorporate QuestAir's M-3200 units.

We have also seen encouraging progress in the Canadian biogas market. In July, the British Columbia Government announced funding for several clean energy projects through the Innovative Clean Energy ("ICE") Fund. We expect to supply biogas upgrading plants for two of these projects, including a \$1.1 million biogas upgrading project at the Lions Gate Wastewater Treatment Plant in West Vancouver. The project will recover and upgrade biogas generated from the digestion of municipal sewage. We are working with Terasen, the local gas utility, and Metro Vancouver (the owner of the waste water treatment facility) on this project, which is expected to supply renewable energy to heat approximately 100 homes.

In September, we entered into a Memorandum of Understanding with Terasen, to work jointly on the development of potential projects to produce supplies of biomethane from organic waste. Renewable natural gas generated from these projects would be injected into Terasen's existing pipeline system for distribution to homes and businesses.

In the hydrogen purification market, we made less progress than anticipated during fiscal 2008. We secured a number of orders for our H-3200 PSAs, including the sale of two H-3200 PSAs for hydrogen plants in Mexico and Russia and three hydrogen PSAs sold to Iwatani for the Japanese market. However, we did not achieve our objective of growing the hydrogen PSA business in fiscal 2008. In the refinery hydrogen market, we achieved a substantial technical success with the completion of the field test of our H-6200 hydrogen purifier at an ExxonMobil affiliate refinery in France. However, our marketing efforts in the refinery market were impacted by the recent drop in oil prices, as well as by delays in certain target customer projects that impacted near-term H-6200 sales prospects. Consequently, we did not meet our objective of securing our first commercial order of an H-6200 during the year.

We took measures during fiscal 2008 to continue to reduce our operating costs. In March 2008, we announced a corporate reorganization that included the elimination of 13 full time positions, which is expected to result in annualized savings of \$1.25 million. Importantly, we also announced a new engineering service contract with EMRE valued at US\$6.35 million, to allow for the further development and commercialization of QuestAir's rapid-cycle PSA technology. This agreement has allowed us to

redeploy resources towards customer-funded development activities, substantially reducing our research and development expenses going forward.

The combination of the new agreement with EMRE and the cost-saving measures allowed us to revise our financial guidance for fiscal 2008. In March 2008, we raised our forecasted revenue guidance for fiscal 2008 to a range of \$11 million to \$12 million, from prior guidance of \$9 million to \$10 million. At the same time, we lowered our guidance for cash used in operations and capital expenditures for fiscal 2008 to be in the range of \$6.5 million to \$7.5 million, compared to prior guidance of less than \$8 million. As is discussed in more detail below, our financial results for fiscal 2008 were within these revised guidance ranges.

In the third quarter of the fiscal year, we successfully completed an equity offering, raising gross proceeds of \$9 million. The subsequent credit crisis and collapse of the equity markets highlights the importance of having completed the offering when we did. The funds raised provide substantial liquidity to the Company with which to weather the current economic crisis.

In December 2007, we published a number of operational and financial milestones for fiscal 2008. The table below summarizes our performance against these milestones:

Milestone	Progress
1. Enhance our commercial footprint in the biogas market	As discussed above, we made considerable progress in the biogas purification market. We exceeded our target of signing at least one distribution agreement with a biogas developer, by entering into supply and distribution agreements with Phase 3 and Verdesis. However, we did not meet our objective of securing at least three new customers in this market.
2. Grow our industrial hydrogen business	During the year, we did not increase the total value of our hydrogen business, and did not secure as many large system sales as we expected.
3. Secure first purchase order for a commercial H-6200 hydrogen purifier	Although the field test of the H-6200 prototype was successfully completed in March 2008, we were not able to secure a purchase order for the first commercial H-6200 hydrogen purifier.
4. Increase recognized revenue to between \$9 and \$10 million in fiscal 2008	As noted above, in March 2008 we increased our revenue guidance for fiscal 2008 to \$11 to \$12 million, which was achieved.
5. Manage cash used in operations and capital expenditures to less than \$8 million	As noted above, in March 2008 we reduced our cash usage guidance for fiscal 2008 to \$6.5 to \$7.5 million, which was achieved.

**Financial Overview**

The financial highlights for the year ended September 30, 2008 are noted below:

- Revenue was \$11.4 million for the year, an increase of \$4.4 million or 63% compared to fiscal 2007. This is the highest revenue achieved in QuestAir’s history, and represents a substantial improvement over the prior fiscal year. The growth in revenues was driven by fourth quarter

performance, with record quarterly revenue of \$4.9 million being recognized in the final quarter of the fiscal year.

- Sales order backlog at September 30, 2008 was \$10.9 million, a decrease of \$0.2 million, or 2%, from September 30, 2007.
- Cash used by operations and capital requirements was \$7.1 million for the year, a decrease of \$3.4 million or 33% compared to fiscal 2007. Management's efforts to reduce cash usage in March 2008 paid off considerably in the second half of the fiscal year, with cash usage for the last six months of fiscal 2008 totaling \$2.1 million compared to \$5.2 million in fiscal 2007, and \$5.0 million for the first half of fiscal 2008.
- Net loss was \$7.6 million (\$1.09 per share) for the year, a decrease of \$4.8 million or 38% from \$12.4 million (\$2.37 per share) in fiscal 2007. The net loss fell considerably as a result of lower operating expenses and higher margins in fiscal 2008 compared to the prior year.

### Selected Financial Information

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

(\$'000)	For the years ended September 30,		
	2008	2007	2006
Revenue	11,432	7,012	7,558
Net research and development expenses	3,004	4,801	5,092
General and administrative expenses	3,981	3,668	3,311
Net loss	(7,643)	(12,417)	(10,263)
Loss per share	(1.09)	(2.37)	(2.42)
Total assets	17,505	17,053	27,682
Total long-term liabilities	228	454	533
Backlog (unaudited)	10,868	11,054	5,044

Our revenues have fluctuated over the past three years as a result of timing of revenue recognition on sales of gas purification systems, as well as fluctuations in the amount of revenue recognized from the sale of the prototype H-6200 hydrogen purifier (the "prototype plant") and from engineering service contracts, both of which are recognized on a percentage-of-completion basis. The fluctuation in revenue over this time period has been accompanied by growth in sales order backlog, reflecting the growth in the total volume of business for the Company. Backlog increased 119% in fiscal 2007 as a result of strong growth in purchase orders for commercial equipment. This level of backlog was sustained in fiscal 2008 in part from the receipt of an engineering service contract valued at US\$6.35 million from EMRE to enable the further development and commercialization of our rapid-cycle PSA technology.

Net research and development ("R&D") expenses declined over the past three years as certain development activities were completed and resources were transitioned towards commercial activities, including the construction of the prototype plant that was sold to an ExxonMobil refinery and work performed under funded engineering service contracts with EMRE. R&D expenses fell in spite of the fact that we saw a decrease in offsetting government funding over the past three years. Funding under the Technology Partnerships Canada ("TPC") program, which was deducted from gross R&D expenditures in fiscal 2006 and the first quarter of fiscal 2007, has concluded and no amounts were claimed in fiscal 2008.

General and Administrative ("G&A") expenses have increased over the past three years, largely due to restructuring activities in each of fiscal 2007 and 2008. In May 2007 and March 2008 we reorganized our

operations to reduce R&D expenditures, resulting in severance and termination benefits being incurred as a G&A expense in each of these years. The reduction in development staffing allowed for consolidation of our facilities at the end of fiscal 2008, which will further reduce our operating expenses going forward. As a result of these reorganizations, our G&A and R&D expenses are expected to decline in fiscal 2009.

Net loss fluctuations over the past three years are due to reductions in R&D over the three years and to higher gross profits in 2008. Gross profits in prior years were diminished due to losses being recognized on the sale of the prototype plant in each of fiscal 2006 and 2007 (see ‘Results of Operations’).

Total assets have fluctuated over the past three years, and include funds raised from QuestAir’s initial public offering (“IPO”) in fiscal 2005 and the subsequent equity offerings in fiscal 2006 and fiscal 2008 as discussed in ‘Use of Proceeds from our Public Offerings’. The decrease in fiscal 2007 reflects cash used in operations in the absence of a financing transaction in the year.

**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:

	For the years ended September 30,	
	2008	2007
Gas purification systems	7,757,981	6,322,595
Engineering service contracts	3,674,275	689,571
Total revenue	11,432,256	7,012,166

Total recognized revenue for fiscal 2008 was the highest in the Company’s history, increasing 63% compared to the prior period. Revenue from gas purification systems was up 23% year over year, while revenue from engineering service contracts increased four-fold over the prior year. Recognized revenue from gas purification systems included a number of biogas purification systems, including an M-3100 system to upgrade anaerobic digester gas created from agricultural waste to pipeline quality methane in the United States and several M-3200 PSA systems to recover pipeline or vehicle-fuel grade methane from biogas.

The increase in revenue from engineering service contracts reflects the higher value of these contracts in backlog compared to the prior periods (discussed in more detail below). This trend is expected to continue for several quarters as a result of the US\$6.35 million engineering service contract with EMRE that was entered into in March 2008, which will elevate the revenue recognized from engineering service contracts until it is completed in December 2009.

Fluctuations in recognized revenue and the receipt of new sales orders are to be expected in the markets that we 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, 2008 and 2007.

(Unaudited)	For the year ended September 30, 2008			For the year ended September 30, 2007		
	Gas Purification Systems	Engineering Service Contracts	Total	Gas Purification Systems	Engineering Service Contracts	Total
Opening Balance	8,954,635	2,099,130	11,053,765	4,908,298	135,594	5,043,892
Bookings	3,574,586	6,482,200	10,056,786	10,802,921	2,809,275	13,612,196
Revenue	(7,757,981)	(3,674,275)	(11,432,256)	(6,322,595)	(689,571)	(7,012,166)
Adjustments <sup>2</sup>	731,202	458,391	1,189,593	(433,989)	(156,168)	(590,157)
Ending Balance	5,502,442	5,365,446	10,867,888	8,954,635	2,099,130	11,053,765

The total sales order backlog decreased by \$185,877, or 1.7%, during fiscal 2008, and the mix of orders in backlog changed considerably compared to the prior period. The total value of new orders received in the year was \$1,375,470 less than the amount of revenue recognized in the year. This was largely offset by favourable foreign exchange adjustments of \$1,189,593 during the year.

New orders for gas purification systems were markedly lower than the prior year, due to a number of factors. The strong Canadian dollar for much of fiscal 2008 made the Company's products less competitive in the United States, which resulted in lower sales and reduced margins on US denominated contracts. Further, the Company's low cash balances prior to completing an equity offering in the third quarter of fiscal 2008 adversely impacted our ability to secure certain orders due to customer uncertainty about our financial position. Later in the year, our sales activities were hampered by the credit crisis and the drop in oil prices, which management believes contributed to certain target customers delaying projects. Finally, we did not meet our objective of securing our first commercial order of an H-6200 during the year, contributing to lower PSA bookings.

In the European biogas market, delays in the ratification of government incentives for biogas upgrading projects in Germany (referred to as the EEG Act) resulted in the delay in a number of biogas projects in the German market, which directly impacted sales prospects for QuestAir's PSA systems. In spite of these challenges, we received several orders for our methane purification products during the year, including an order for an M-3200 for use in the "Biomethane for Vehicle Fuel" project located at the Hilarides Dairy in California. Orders for hydrogen purification products included an order valued at approximately \$1 million for an H-3100 hydrogen PSA system from Iwatani to be used in a new hydrogen recovery project in Japan.

During fiscal 2008, we signed a significant engineering service contract with EMRE valued at US\$6.35 million, which accounted for the majority of our new engineering service contract bookings in the year. This new contract has allowed us to redirect resources towards funded development work, lowering our R&D expenses and cash usage while funding additional development of our rapid-cycle PSA technology.

### **Gross Profit**

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

	For the years ended September 30,	
	2008	2007
Revenue	11,432,256	7,012,166

<sup>2</sup> Includes adjustments for fluctuations in foreign currency exchange rates.



Cost of goods sold	8,030,894	7,007,989
Gross Profit	3,401,362	4,177
Gross Margin (%)	29.8%	0.1%

Gross profit increased in fiscal 2008 compared to the prior year due in part to an increase in the amount of revenue recognized on engineering service contracts, which tend to generate higher gross margins than equipment sales. In addition, gross profit was significantly lower in the prior fiscal year due to losses being recognized on the sale of the prototype H-6200 plant. Margins are expected to fluctuate from year to year depending on the mix of revenues recognized from engineering service contracts and gas purification systems.

**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:

	For the years ended September 30,	
	2008	2007
Gross R&D Expenditure	3,004,486	5,175,521
Government & Partner Funding	-	(374,929)
Net R&D Expenditure	3,004,486	4,800,592

In fiscal 2008, management decided to limit the amount of self-funded research and development activities in order to reduce its operational cash usage. As a result, the Company underwent a reorganization to reduce development-related staffing and entered into a US\$6.35 million engineering service contract with EMRE to fund additional development of the Company’s rapid-cycle PSA technologies. The contract has allowed QuestAir to redeploy a significant amount of its human resources from self-funded research and development activities to funded engineering service contracts. As a result, we saw a 37% reduction in net R&D expenditures for fiscal 2008 compared to the prior year. Government funding recorded in the prior year related to the final claim for eligible expenditures from the TPC contribution agreement (see also ‘Contingent Off-Balance Sheet Financing Arrangements’).

**General and Administrative**

G&A expenses increased in fiscal 2008 to \$3,981,456 from \$3,667,755 for the prior year. In each of fiscal 2008 and 2007, the Company restructured operations and terminated employees, resulting in severance costs and termination benefits of \$955,080 and \$564,030 being recorded in G&A expenses in fiscal 2008 and 2007 respectively. Higher restructuring costs in fiscal 2008 were partially offset by lower stock-based compensation expense in the current fiscal year. Stock-based compensation expense decreased 35% to \$297,131 in fiscal 2008, as several options became fully vested or were forfeited during the prior and current fiscal years.

**Sales and Marketing**

Sales and marketing expenses were \$1,796,842 for fiscal 2008, a decrease of 15% compared to \$2,117,706 for the prior year. The reduction in sales and marketing expenses for fiscal 2008 reflects a decrease in variable selling costs resulting from lower gas purification equipment orders compared to the prior year.

**Operations**

This is the first fiscal year that “Operations” appears as a caption on our financial statements, and is the result of the restructuring undertaken in the prior fiscal year to increase resources dedicated to commercial activities and to reduce R&D expenditures. Consistent with our accounting policy,



comparative amounts have been reclassified where necessary to conform to the presentation adopted in the current fiscal year. Included in Operations are expenses related to supply chain management, shipping and receiving, quality management and non-development related engineering activities. Operations expenses were \$1,478,150 for fiscal 2008 compared to \$936,951 for the prior year, with the increase primarily due to the addition of human resources to the department.

***Amortization***

Amortization expenses decreased 14% to \$734,121 in fiscal 2008 as a result of certain capital assets becoming fully amortized during the year.

***Other Income and Expense***

Other income and expense netted to an expense of \$49,240 for fiscal 2008 compared to \$47,752 in the prior year. Royalty expense includes a \$495,037 unconditional, one-time payment to TPC related to the amendment agreement entered into during fiscal 2008. Interest income and gains from foreign exchange fluctuations and embedded derivatives partially offset other expenses in the current year.

***Net Loss***

Net loss declined 38% in fiscal 2008 compared to the prior year, reflecting the higher gross profit in the year as well as lower R&D expenses. Net loss for fiscal 2008 was \$7,642,933 or \$1.09 per share, compared to \$12,417,412, or \$2.37 per share, for the prior year. Loss per share is calculated based on the weighted average number of common shares outstanding through the year. Loss per share decreased in the current year as a result of a decrease in the net loss compared to the prior year and an increase in the weighted average number of common shares outstanding upon completion of our equity financing in June 2008 (refer to ‘Outstanding Share Data’).

***Capital Expenditures***

Capital expenditures net of government funding and proceeds on sale (“Net CAPEX”) for fiscal 2008 were \$342,926 compared to \$412,249 for the prior year. Net CAPEX were higher in the prior year due to the addition of a three-year capital lease in fiscal 2007. 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 offerings in our prospectuses dated May 23, 2006 and May 7, 2008. Net cash proceeds from the IPO were \$11,694,571, while net cash proceeds from the equity offerings in 2006 were \$18,410,751 and in 2008 were \$7,918,882. As at September 30, 2008, we had used \$28,415,902 of this amount to fund our operating activities. As at September 30, 2008, \$1,689,420 from the 2006 equity offering and the entire \$7,918,882 net proceeds from the 2008 equity offering remain available for the uses described in the prospectuses, and we intend to use these funds as described in the prospectuses. However, circumstances may arise which may result in a reallocation of funds for sound business reasons.

The table below compares the estimated use of proceeds disclosed in our May 2006 prospectus to the actual results as at September 30, 2008.

Use of Proceeds Noted in Prospectus	Prospectus Comment	Actual Use to September 30, 2008
Sales and Marketing:	To drive sales growth and expand the	22%

Approximately 25%	Company's market channels	
Research and Development: Approximately 40%	To develop and commercialize products for the Company's hydrogen, methane and fuel cell related markets	43%
Capital Expenditures: Approximately 15%		4%
Working capital, general corporate purposes: Approximately 20%	In conjunction with funds from operations, for working capital and general corporate purposes.	31%

The proportion of spending on working capital and general corporate purposes was higher than expected as a result of costs associated with the reorganization of operations during fiscal 2007 and 2008 as well as increased costs associated with the prototype plant in fiscal 2007. This increase was offset by lower-than-expected spending on capital assets, as required investments in manufacturing-related equipment have been lower than previously expected.

### Summary of Quarterly Results

(Unaudited, \$ '000 except loss per share data)	2008				2007				2006			
	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31
Total Revenues	4,864	2,702	2,298	1,568	880	3,616	873	1,643				
Gas Purification Systems	3,747	1,300	1,348	1,363	709	3,333	858	1,423				
Eng. Service Contracts	1,117	1,402	950	205	171	283	15	220				
% Gross Margin	21%	40%	45%	16%	(15%)	34%	(157%)	17%				
R&D (net)	704	411	934	956	1,025	1,424	1,348	1,003				
General & Administrative	1,138	769	1,190	886	772	1,233	903	760				
Net Loss	1,613	1,582	2,057	2,390	2,989	2,559	4,644	2,225				
Net Loss per share	(0.14)	(0.25)	(0.39)	(0.45)	(0.57)	(0.49)	(0.89)	(0.42)				
Net CAPEX	57	45	87	154	15	37	99	261				
Cash used in Operations & Net CAPEX	1,582	512	2,166	2,827	2,947	2,264	1,210	4,105				
Backlog	10,868	14,502	16,022	10,141	11,054	7,136	7,513	5,819				
Gas Purification Systems	5,502	8,328	8,390	8,144	8,955	6,660	7,078	5,697				
Eng. Service Contracts	5,366	6,174	7,632	1,997	2,099	476	435	122				

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

Revenues and gross margins fluctuate quarter to quarter based on the mix of recognized revenue from gas purification equipment and engineering service contracts, which in turn is impacted by the length of the sales cycle required to close a customer order, and by contractual terms related to the timing of delivery and acceptance of products and services by customers. In the quarters ended March 31, 2007 and September 30, 2007 we recognized losses on the prototype plant, contributing to the quarterly fluctuation in percentage gross margins.

Net R&D expenses have declined over the most recent four quarters as the company shifts its focus to commercial activities. G&A expenses have varied quarter by quarter, largely as a result of quarterly

variations in legal, regulatory and investor relations costs, and specific to the quarters ended June 30, 2007; March 31, 2008; and September 30, 2008 severance and termination benefits associated with the restructuring of our operations and termination of employees.

Cash usage has declined in recent quarters, reflecting lower operating expenses as a result of restructuring activities noted above.

***Review of the Fourth Quarter ended September 30, 2008***

Revenues for the quarter ended September 30, 2008 were the highest in the Company’s history, totaling \$4,864,321, with revenues from both gas purification sales and engineering service contracts increasing compared to the same period last year. Sales order backlog was \$10,867,888 at September 30, 2008, a decrease of 25% from \$14,502,466 at June 30, 2008, reflecting the increased amount of revenue recognized in the fourth quarter. Cash used in operations and capital expenditures for the quarter ended September 30, 2008 was \$1,582,070, a decrease of 46% from \$2,947,643 in the same period in 2007, driven by higher gross profit in the current quarter. The net loss for the quarter ended September 30, 2008 was \$1,612,807, a decrease of 46% from \$2,989,025 in the same period in 2007.

**Cash Flows, Liquidity and Capital Resources**

***Cash Flows***

Cash and cash equivalents were \$9,265,249 at September 30, 2008, an increase of \$3,539,004 from \$5,726,245 at September 30, 2007. This increase in cash and cash equivalents during the year was driven by cash inflows from financing activities, partially offset by cash outflows from operating activities.

Cash used by operations for fiscal 2008 decreased 33% to \$6,744,157 compared to \$10,113,209 for the prior year. The decrease in cash used by operations for the year was driven by the decreased loss for the year, partially offset by a decrease in cash inflows from deferred revenue compared to the prior year.

Cash provided by investing activities declined to \$2,715,270 in fiscal 2008, compared to \$4,842,856 in the prior year. Fewer short-term investments matured and less restricted cash was released during the year compared to the prior year.

Cash provided by financing activities was \$7,567,891 in fiscal 2008, reflecting net cash proceeds from an equity offering that was completed in June 2008. No similar financing occurred in the prior year.

Cash used by operations and capital requirements decreased 33% in fiscal 2008 to \$7,087,083, compared to \$10,525,458 for the prior year. The decrease in cash usage reflects the lower net loss for the year compared to fiscal 2007.

The calculation of this measure of cash usage and a reconciliation of this financial measure to the statement of cash flows is as follows:

	For the years ended September 30,	
	2008	2007
Cash used in Operating Activities	(6,744,157)	(10,113,209)
Add: Purchase of property, plant and equipment (“PP&E”)	(364,768)	(426,729)
Add: Government grants and funding related to PP&E	-	5,434
Add: Proceeds from sale of PP&E	21,842	9,046
Cash used in Operations and Capital Requirements	(7,087,083)	(10,525,458)

Reconciliation to GAAP Statements of Cash Flow:		
Add: Short term investments	2,998,399	4,339,553
Add: Restricted cash	59,797	915,552
Add: Cash from financing activities	7,567,891	(22,202)
Increase (decrease) in Cash and Cash Equivalents	3,539,004	(5,292,555)

### ***Liquidity and Capital Resources***

Since incorporation, we have financed our operations through cash generated from revenue, the issuance of equity and funding received from government and strategic partners. At September 30, 2008 cash and short-term investments were \$9,327,297, compared to \$8,786,692 at September 30, 2007. Not included in cash and short term investments at September 30, 2008 was \$281,005 of restricted cash to secure letters of credit with customers compared to \$340,802 at September 30, 2007. At the forecast cash burn rate, we have sufficient financial resources to fund our operations for more than 12 months.

During the fiscal year we raised gross proceeds of \$9,000,000 through the offering of 60,000,000 subscription receipts and the completion of the exchange of each subscription receipt into one unit consisting of one common share and one common share purchase warrant. Net proceeds from the offering were \$7,918,882 after share issuance costs of \$1,264,718, including \$183,600 of non-cash expenses.

Our cash resources will be used to promote sales and fulfill orders for our commercial products, as well as to advance the development and commercialization of products under development. 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.

Our working capital requirements are met through our current cash reserves, current accounts and future progress payments not yet invoiced related to orders in backlog. Our standard contract terms for equipment sales require customers to pay progress payments for eighty percent of the total value of the order prior to shipment of the goods; this serves to fund our working capital for inventory purchases, and also reduces our credit risk.

Historically, our accounts receivable collection has been very strong, with zero bad debt expense in the prior five fiscal years. However, the recent liquidity crisis and economic downturn has created financial difficulties for a small number of our customers in the past few months. As a result, in the fourth quarter of fiscal 2008, we recorded a provision for doubtful accounts for the first time in more than five years as well as a small bad debt expense. Importantly, the majority of our receivables are with creditworthy, high-quality customers, which mitigates our credit risk. Nevertheless, we will continue to monitor the Company's credit risk closely.

### ***Credit Facilities***

During fiscal 2005, we signed a credit facilities agreement with Comerica Bank. This agreement is amended and restated each year as part of the annual renewal of these facilities, most recently in June 2008. The amended credit facilities include a US\$1 million accounts receivable line of credit and a US\$1 million term loan, in addition to amounts outstanding under the prior term loan agreements. Both facilities are secured by the assets of the Company with certain exceptions. As at September 30, 2008, we had drawn \$671,607 against the term loans net of repayments, which includes \$190,924 drawn under

the amended term loan. We expect to use the equipment line to fund capital expenditures, and we may use the accounts receivable line to fund working capital requirements from time to time. At September 30, 2008 we are in compliance with all of our bank covenants.

***Contractual Obligations***

The following table lists our contractual obligations at September 30, 2008. We expect to fund these expenditures out of our cash reserves, current accounts receivables and future progress payments not yet invoiced related to orders in backlog:

(Unaudited)

	Total	In the next year	2-3 years	After 4 years
Bank debt	671,607	443,345	228,262	-
Capital leases	105,479	105,479	-	-
Operating leases	1,029,184	350,814	678,370	-
Purchase obligations <sup>3</sup>	1,025,773	1,025,773	-	-
<b>Total contractual obligations</b>	<b>2,832,043</b>	<b>1,925,411</b>	<b>906,632</b>	<b>-</b>

If our debt facilities with Comerica Bank were terminated or not renewed, amounts currently classified as long-term would become due and payable within the current year. Termination of our debt facilities without replacing them with a new facility would also result in reduced cash on hand, reduced interest expenses, and decreased borrowing capacity. Termination of our debt facilities is not anticipated.

Termination of our leases may require us to continue to pay the full amounts shown in the above table, unless, in the case of operating leases, we are able to sublet the premises under lease.

Our purchase obligations relate primarily to work in progress, therefore, termination of these obligations may impact our ability to fill customer orders in backlog. In many cases, termination of our purchase obligations would not result in reduced financial obligations, although in certain circumstances reduced payments may be possible.

**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:

***Technology Partnerships Canada***

At September 30, 2008, we had received \$8,139,937 under a conditionally repayable loan under the TPC funding program, through an agreement administered by Industry Canada. These funds are repayable in the form of annual royalties under certain conditions. During the year we finalized negotiations with TPC to amend this agreement to, among other things, eliminate certain development milestones, extend the program completion date for certain other milestones, and reduce the contribution amount and the associated royalties. Details of the amendment are contained in note 14 of the Company’s audited financial statements for fiscal 2008. Amounts drawn under this contribution agreement are subject to final audit by Industry Canada.

<sup>3</sup> 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 entered into a similar funding arrangement with TPC in 1999 and received a total of \$4,762,503 in funding from March 1999 to July 2002. The funding is also repayable under certain conditions. The repayment obligations and total royalty repayments made to date for these funding programs are listed below:

<b>Funding Award Date</b>	<b>Description</b>	<b>Royalties</b>	<b>Term</b>	<b>Royalty Payments to Date</b>
June 6, 2003	Fast Cycle Pressure Swing Adsorption	Annual royalties of 1.165% of gross business revenues	The royalty period began on October 1, 2005 and will end on the earlier of September 30, 2022 or until a cumulative royalty ceiling of \$18.8 million is reached. In addition, a one-time unconditional royalty payment of \$495,037 is payable before November 28, 2008.	Total cumulative payments: \$169,744 Accrued for future payment: \$754,834
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.	Total cumulative payments: \$56,347 Accrued for future payment: \$389

***Department of Natural Resources Efficiency and Alternative Energy Program***

In 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. In 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:

<b>Funding Award Date</b>	<b>Description</b>	<b>Royalties</b>	<b>Term</b>	<b>Royalty Payments to Date</b>
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.	Total cumulative payments: \$4,338 Accrued for future payment: \$1,253
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.	Total cumulative payments: \$0 Accrued for future payment: \$0



**Outstanding Share Data**

***Common Shares Outstanding***

Our authorized share capital consists of an unlimited number of common shares, of which 11,269,318 common shares were issued and outstanding as of November 30, 2008. We also have an unlimited number of preferred shares authorized, none of which are issued.

On May 13, 2008, we completed an offering of subscription receipts, which were automatically converted into common shares and share purchase warrants following receipt of shareholder approval of the offering on June 16, 2008. On June 27, 2008, we completed a common share consolidation on a 10 for 1 basis, reducing the number of common shares outstanding from 112,683,647 to 11,268,318. All share data in this MD&A and in the associated financial statements for the period ended September 30, 2008 are reported on a consolidated basis and the basic and diluted earnings per share data have been adjusted retroactively for all periods presented to reflect the common share consolidation.

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

	For the years ended September 30,	
	2008	2007
Weighted Average Common Shares Outstanding	7,019,409	5,247,331

The average number of common shares outstanding increased for the year ended September 30, 2008 compared to the prior year as a result the issuance of 6,000,000 new common shares as a result of the equity offering completed during the year.

***Stock Options and Warrants Outstanding***

As at November 30, 2008 there were 340,758 stock options outstanding with an average exercise price of \$8.30, of which 215,817 were exercisable. As at November 30, 2008 there were 6,180,000 warrants outstanding compared to 19,231 warrants outstanding at September 30, 2007 which expired unexercised on June 6, 2008. The outstanding warrants were issued in conjunction with the equity offering and expire on May 13, 2010. Of the warrants issued and outstanding, 6,000,000 have an exercise price of \$2.15 and 180,000 have an exercise price of \$1.50.

**Related Party Transactions**

There were no related party transactions during the year ended September 30, 2008.

**Outlook**

As we enter fiscal 2009, we are facing a challenging economic environment in certain market segments. In the biogas market, growth prospects in the European market remain strong. The passing of the amendment to the EEG Act introduced subsidies for biogas upgrading projects, which is expected to drive significant growth in the German market in 2009. In the North American biogas market, the fall in natural gas prices from \$10-12/mmBtu range to around \$5-6/mmBtu is expected to have some impact on marginal biogas projects, particularly some single farm projects where the economies of scale are not strong. However, the longer term macro-economic drivers of the biogas market in North America remain strong and a growing number of gas utilities and governments in North America are actively supporting



the development of biogas upgrading projects as a source of renewable natural gas. In addition, the production of renewable CNG vehicle fuel from biogas represents a significant value-added end use of biogas that we expect to drive additional growth in the biogas upgrading market.

In the hydrogen market, demand in the oil refining and steel manufacturing sectors is expected to fall as a result of the current economic climate. However, in some cases this may mean that capital projects are scaled back, resulting in the purchase of smaller capacity hydrogen plants or purification systems (a market where QuestAir has a competitive advantage). We will continue to sell our hydrogen PSAs to existing customers in markets where we have a competitive advantage and focus on industries and geographies where demand for hydrogen remains strong.

In the refinery hydrogen market, the economic climate has affected our business. Oil prices have declined over 65% from their peak in July, due to concerns over a slowing global economy. In turn, many oil refineries have delayed capital projects and reduced capital spending. While we believe that the market opportunity for the H-6200 refinery hydrogen purifier remains strong, both within ExxonMobil's own refinery circuit and with third-party customers, we expect to see some delay in the development of additional H-6200 projects, and we do not have adequate visibility to forecast an H-6200 sale in fiscal 2009.

Over the past few months, we have seen a small number of prospective orders cancelled or delayed due to economic uncertainty or the lack of available credit. While uncertainty can be expected to continue for some time, we are optimistic that government initiatives to increase available credit will help provide the financing that certain customers require for their capital investments. It should also be noted that many of our customers have very strong balance sheets, and do not require external financing for their projects.

On a positive note, the recent decline in the Canadian dollar compared to the US dollar has made our products more competitive in our primary export market. If the current value of the Canadian dollar is sustained in fiscal 2009, we would expect to win more orders in the United States and we should see our margins increase on current orders in backlog.

In addition, we have developed our products to be successful in the type of competitive, cost-conscious environment that we are in today. The advantages of QuestAir's PSA systems over competing products includes a more compact, space-efficient and reliable technology that allows for lower installation and operating costs, and a lower total cost of ownership.

Despite current economic conditions, management is confident that QuestAir is well positioned going forward from a cash, product and strategy standpoint. Fiscal 2009 will be an important year in terms of building out our biogas-focused strategy while ensuring that we continue to serve our core customers in the hydrogen market. In the biogas market, our key areas of focus over the coming year will include:

- Growth of sales of biogas PSAs to key partners and systems integrators including Verdesis and Phase 3;
- Receipt of initial orders for integrated biogas upgrading plants and expansion of our product and service offerings to include operating and service contracts to support these initial plant sales; and
- Expansion of market channels through additional partnerships with project developers and/or gas utilities, particularly in the biogas-to-CNG market segment.

In the hydrogen market, we continue to focus on improving the competitiveness of our hydrogen PSA product line, through performance improvements and cost reductions. These steps are intended to support our core hydrogen customers in the hydrogen plant and hydrogen recovery markets. Moreover, the similarity between our hydrogen and methane PSAs will allow us to utilize these improvements and cost reductions in the biogas market as well.

In the refinery hydrogen market, we will focus on completing key deliverables in our existing engineering service contract with ExxonMobil while continuing to support ExxonMobil's marketing of the H-6200 hydrogen purifier.

Looking at our projected financial performance for fiscal 2009, our strong order backlog as at September 30, 2008 will support our revenues in fiscal 2009, which we forecast to be in the range of \$10 million to \$12 million, compared to \$11.4 million in fiscal 2008. Our continued focus on prudent cash management and reducing our investment in self-funded R&D means we will see further reductions in cash burn in fiscal 2009. We are forecasting cash used in operations and capital expenditures of \$4 million to \$5 million, down from \$7.1 million in fiscal 2008.

### **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 financial statements for the financial year ended September 30, 2008.

#### ***Revenue Recognition***

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

During the year ended September 30, 2008 and 2007 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, 2008, raw materials on hand of \$823,006 includes \$47,360 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 2008 and 2007, actual warranty costs incurred were less than the provision recorded.

### **Changes in Accounting Policies Including Initial Adoption**

#### ***Capital Disclosures***

The CICA issued Handbook Section 1535, *Capital Disclosures*, which establishes standards for disclosing information about an entity's capital and how it is managed. These changes come into effect for fiscal years beginning on or after October 1, 2007; accordingly, we have adopted this new standard effective October 1, 2007. As this standard relates only to disclosure requirements, this section does not have an impact on our financial results.

#### ***Accounting Changes***

The CICA has issued Section 1506, *Accounting Changes*, which establishes criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and correction of errors. As a result, changes in accounting policies are only permitted when required by a primary source of GAAP or when the change will result in reliable and more relevant information. These changes come into effect for fiscal years beginning on or after January 1, 2007; accordingly, we have adopted this new standard effective October 1, 2007. At this time, we are not aware of any pending accounting changes other than those mandated by the CICA, and as such we do not anticipate any material effects as a result of this change.

#### ***Inventories***

The CICA issued Section 3031, *Inventories*, which supersedes the previously issued standard on inventory and introduces significant changes to the measurement and disclosure of inventory. The measurement changes include: the elimination of LIFO and the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. Disclosures of inventories have also been enhanced. Inventory policies, carrying amounts, amounts recognized as an expense, write-downs and the reversals of write-downs are required to be disclosed. This new standard comes into effect for fiscal years beginning on or after January 1, 2008; accordingly we will adopt this new standard on October 1, 2008. We are assessing the impact this standard will have on our financial statements.

### ***Goodwill & Intangible Assets***

The CICA has issued new accounting recommendations for goodwill and intangible assets which establish standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets (including internally developed intangible assets). These recommendations are effective for the Company beginning October 1, 2008. Goodwill and intangible assets that are not assets as defined by GAAP will be derecognized and charged to the equity of the Company at that date. We are evaluating the effect of these recommendations on our financial statements.

### **Financial Statement Preparation**

The CICA has revised section 1400, *General Standards of Financial Statement Presentation*, which requires management to make an assessment of, and disclose material uncertainties related to, the ability of an entity to continue as a going concern. This new standard comes into effect for fiscal years beginning on or after January 1, 2008; accordingly QuestAir will adopt this new standard in fiscal 2009. The Company is assessing the impact this standard will have on its financial statements.

### ***International Financial Reporting Standards***

On February 13, 2008, the Canadian Accounting Standards Board confirmed that International Financial Reporting Standards will replace Canada's current generally accepted accounting principles for publicly accountable profit-oriented enterprises for interim and annual financial statements effective January 1, 2011. The Company is presently considering the effect these standards will have on its financial statements.

### **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 the Canadian Securities Administrators rules and forms. The Company evaluated its disclosure controls and procedures as defined under Multilateral Instrument 52-109 for the year ended September 30, 2008. 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, 2008. 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**

The Company's ability to generate revenue and profit from operations is subject to a number of risks. The risks and uncertainties described below are not the only ones QuestAir faces. Additional risks and uncertainties, including those that the Company is not aware of now or that management may believe are currently not material, may also adversely affect the ability to generate a viable business. The risk factors presented below are divided into categories of risks impacting QuestAir's internal and external environment. Specific risks within each category are listed in approximate order of seriousness, from most to least serious.

### **Risk factors related to QuestAir's business**

#### ***The Company has a limited operating history and it may be difficult to assess its business and future prospects.***

The Company commenced operations in 1997 and since that time, the Company has been engaged in the development, manufacture and supply of PSA systems. The Company has made limited sales of PSA systems to date and has incurred substantial losses since its founding. These losses are expected to continue for the foreseeable future. For the year ended September 30, 2008, the Company's sales totalled \$11.4 million and its accumulated deficit totalled \$115.1 million. The Company's historical operating data may be of limited value in evaluating QuestAir's future prospects. The Company cannot predict when it will operate profitably, if ever.

#### ***Potential fluctuations in financial results make financial forecasting difficult.***

The Company expects its revenues, expenses, cash flows and other operating results to vary significantly from quarter to quarter. Sales and margins may be lower than anticipated due to general economic conditions and market-related factors, product quality, performance and safety issues and competitive factors. Expenditures and cash receipts may also vary from quarter to quarter due to the timing of such expenditures and cash collections from customers, government entities and other entities providing funding to the Company. As a result, quarter-to-quarter comparisons of revenues, expenses, cash flows and other operating results may not be meaningful. In addition, due to the Company's early stage of development, the Company cannot accurately predict its future revenues, cash flows or results of operations. It is likely that in one or more future quarters, financial results will fall below the expectations of securities analysts and investors. If this occurs, the trading price of the Company's shares may be materially and adversely affected.

#### ***The Company depends upon a limited number of customers for potential revenue due to the nature of its markets.***

To date, a small number of customers have accounted for a majority of the Company's revenues and the Company expects that they will continue to do so for the foreseeable future. For the year ended September 30, 2008, sales to 2 customers accounted for 63% of the Company's total revenue. For the year ended September 30, 2007, sales to 2 customers accounted for 70% of the Company's total revenue.

#### ***The Company sells its products to a limited number of customers, some of which may experience financial difficulty, which may result in bad debts for the Company***

The current financial crisis can be expected to affect the ability of some of the Company's customers to pay their invoices in a timely fashion. The Company sells to customers of varying financial strength and in various geographic locations and markets. Some of these customers, particularly smaller companies with limited financial resources, may be unable to pay their invoices when they become due. This risk is amplified by the current liquidity crisis and general decline in global economies, which is calling into



question the sustainability of some of the Company's customers. The Company mitigates this risk through its standard contract terms for equipment sales, which require payment of the majority of the contract value prior to shipment. Nevertheless, it is possible that some of the Company's customers will default on certain amounts owing.

***The Company's revenue and future prospects depend to a great extent on its relationships with EMRE.***

The Company's business and results of operations would be materially adversely affected if EMRE was to change or terminate its relationship with the Company. There is no guarantee that the interests of the Company will be aligned with the interests of EMRE or that the Company's relationship with EMRE will continue in its current form. Furthermore, any change in EMRE's strategy with respect to PSA technology, whether as a result of market, economic or competitive pressures, could also harm the Company's business. Such a change in strategy could include, for example, any decision by EMRE to:

- alter its commitment to PSA systems in favour of other competing technologies;
- delay its introduction of products incorporating PSA systems; or
- initiate the internal development of PSA systems or to purchase PSA systems from another supplier.

***The Company may be unable to raise additional capital to pursue its long term development and commercialization plans and may be forced to discontinue product development, reduce its sales and marketing efforts or forego attractive business opportunities.***

The Company has not yet realized profitable operations and has relied on non-operational sources of financing to fund its operations. The Company may need to raise additional funds in order to fund its operations. It may also require additional capital to acquire or invest in complementary businesses or products or obtain the right to use complementary technologies. The Company may be unable to raise additional capital or may not be able to do so on acceptable terms to pursue its long-term development and commercialization plans. Either of these outcomes could adversely affect the ability of the Company to respond to competitive pressures or prevent the Company from conducting all or a portion of its planned operations.

The development and commercialization of its products could be delayed or discontinued if the Company is unable to fund its research and product development activities or the development of its manufacturing capabilities. In addition, it may be forced to reduce its sales and marketing efforts or forego attractive business opportunities. If the Company issues additional equity securities in order to raise funds, the ownership percentage in the Company of each of its existing shareholders who do not participate in the financing will be reduced.

***The Company's PSA systems may not meet performance expectations, which could negatively affect its customer relationships and the components of its PSA systems may contain defects or errors that could negatively affect its customer relationships and increase its manufacturing and warranty costs.***

The performance of the Company's PSA system may encounter problems due to the failure of its technology, the failure of the technology of others, the failure to combine these technologies properly, operator error and the failure to maintain and service the systems properly. Many of these potential problems and delays are beyond the Company's control. In addition, poor performance may involve delays in product roll-out and modifications to product design, as well as third party involvement. Any problem or perceived problem with the Company's PSA systems, whether originating from its technology, design, or from third parties, could hurt its reputation and the reputation of its products and limit its sales. Such failures may negatively affect the Company's relationships with customers and may require the Company to extend development longer than anticipated before undertaking commercial sales.

In addition, the Company may be required to offer customers services, products or compensation if the failure of a product to perform results in a claim under the warranties offered by the Company.

***The Company's strategy for the sale of its products depends upon developing key relationships with a number of customers who will incorporate its products into theirs.***

Other than with respect to a limited number of specific markets, the success of the Company's business depends on its ability to develop relationships with parties who will integrate the Company's products into their products. The ability of the Company to sell its products to its target markets depends to a significant extent upon its partners' worldwide sales and distribution network and service capabilities, and there can be no assurance that any future relationships that the Company enters into will not require the Company to share some of its intellectual property. The Company is mitigating this risk in part by developing its own integrated biogas upgrading plants, which will reduce its dependence upon other integrators and project developers.

***The Company will need to recruit, train and retain key management and other qualified personnel to successfully expand its business.***

The Company's future success will depend in large part upon its ability to recruit and retain experienced research and development, engineering, manufacturing, operating, sales and marketing, customer service and management personnel. If the Company does not attract and retain such personnel, the Company may not be able to expand its business. Competition for qualified personnel in its industry is intense. Even if the Company invests significant resources to recruit, train and retain qualified personnel, the Company may not be successful in its efforts. The Company's success also depends upon the continuing contribution of its key management, research, product development, engineering, marketing and manufacturing personnel, many of whom would be difficult to replace.

***The Company currently faces and will continue to face significant competition from other developers and manufacturers of PSA systems and face competition for its PSA systems from developers and manufacturers of other gas purification systems.***

The Company competes with a number of companies that manufacture conventional gas purification equipment and other competing technologies, such as membrane systems. In addition, new developments in technology may adversely affect the development or sale of some or all of the Company's products or make its products uncompetitive or obsolete. Other companies, many of which have substantially greater resources than the Company does, are currently engaged in the development of products and technologies that are similar to, and competitive with, many of its products and technologies. The Company's competition includes numerous companies located throughout the world, some of which may have advantages over the Company in terms of government incentives, labour, component costs and technology. Each of these competitors has the potential to capture market share in the Company's target markets, which would harm its position in the industry. New competitors may also emerge and entire product lines may be threatened by new technologies or market trends which reduce the commercial viability of the Company's product lines. In addition, the Company's customers could potentially become its competitors if they decide to develop and manufacture their own PSA systems.

As the markets for gas purification systems develop, other large industrial companies may enter these fields and compete with the Company. These large industrial companies may have research and development, manufacturing, marketing and sales resources necessary to deliver PSA systems more quickly and effectively than the Company does. In addition, the Company believes that price will become a more important competitive factor as competition increases. The Company may not be able to compete effectively with all of these competitors, which would adversely affect its business, financial condition and results of operations.



***Rapid technological advances could impair the Company's ability to deliver its products in a timely manner, and as a result, its revenues would suffer.***

The Company's success depends in large part on its ability to keep its products current and compatible with evolving technologies and codes and standards. Unexpected changes in technology could disrupt the development of its products and prevent the Company from meeting deadlines for the delivery of products. If it is unable to keep pace with technological advancements and adapt its products in a timely manner, its products may become uncompetitive or obsolete and its revenues would be adversely affected.

***The Company is in the development stage of its second generation PSA systems.***

The Company is in the development stage of its second generation PSA systems and is subject to all the risks and uncertainties inherent in such development. These risks include the successful execution of the Company's product development and commercialization plan, the ability to successfully integrate the modules and components of these systems, and the ability to meet the cost, reliability and performance standards of a viable commercial product.

***The Company depends on its intellectual property and failure to protect that intellectual property could adversely affect the future growth and success of the Company.***

Failure to protect its existing intellectual property rights may reduce the Company's ability to prevent others from using its technology. The Company relies on a combination of patent, trade secret, trademark and copyright laws to protect its intellectual property. Some of its intellectual property is currently not covered by any patent or patent application. The Company does not have, and is unlikely to obtain, complete patent protection for its primary products. The Company's patent protection is subject to complex factual and legal issues that may give rise to uncertainty as to the validity, scope and enforceability of a particular patent. Accordingly, the Company cannot be assured that:

- any of the U.S., Canadian or other patents owned by the Company will not be invalidated, circumvented, challenged, rendered unenforceable, or licensed to others; or
- any of its pending or future patent applications will be issued with the breadth of protection sought by the Company, if issued at all.

In addition, effective patent, trademark, copyright and trade secret protection may be unavailable, limited, not applied for or unenforceable in foreign countries. Litigation may be necessary to enforce its patents and other intellectual property rights. Any such litigation may result in substantial costs and diversion of resources with no assurance of success. Furthermore, although the Company typically retains sole ownership of the intellectual property that the Company develops, its relationships with EMRE and others provide for shared intellectual property rights in certain situations.

The Company also seeks to protect its proprietary intellectual property through contracts, including, when possible, confidentiality agreements and inventors' rights agreements with its customers and employees. The Company cannot be assured that the parties that enter into such agreements with the Company will not breach them, that the Company will have adequate remedies for any breach or that such persons or institutions will not assert rights to intellectual property arising out of these relationships. If necessary, the Company may seek licenses under the patents or other intellectual property rights of others. However, the Company can give no assurances that the Company will obtain such licenses or that the terms of any offered licenses will be acceptable to it. The failure to obtain a license from a third party for intellectual property that the Company uses in the future could cause it to: incur substantial liabilities; suspend the development, manufacturing and the shipment of products; or suspend its use of processes which exploit such intellectual property.

The Company may become subject to lawsuits in which it is alleged that the Company has infringed the intellectual property rights of others or commence lawsuits against others who the Company believes are infringing upon its rights. Its involvement in intellectual property litigation could result in significant expense to the Company, adversely affecting the development of sales of the challenged product or intellectual property and diverting the efforts of its technical and management personnel, whether or not such litigation is resolved in its favor. In the event of an adverse outcome as a defendant in any such litigation, the Company may, among other things, be required to:

- pay substantial damages;
- cease the development, manufacture, use, sale or importation of products that infringe upon other patented intellectual property;
- expend significant resources to develop or acquire non-infringing technology; or
- obtain licenses to the infringing intellectual property.

The complexity of the technology involved and the uncertainty of intellectual property litigation increase these risks. The Company may not be able to develop non-infringing technology or obtain royalty or license agreements on terms acceptable to the Company, or at all. The Company may also be subject to significant damages or injunctions against development and sale of certain of its products.

***The Company has foreign currency risk.***

The majority of the Company's revenues are in US dollars and Euros while most of the operating expenses are in Canadian dollars. Foreign exchange gains and losses are included in results from operations. A large decline in the US dollar or the Euro relative to the Canadian dollar could impair revenues, margins and other financial results. The Company has not entered into foreign exchange contracts to hedge against gains and losses from foreign currency fluctuations.

***The Company is dependent upon third party suppliers for materials and components for its products.***

The Company relies upon third party suppliers to provide materials and components for its products. A supplier's failure to provide materials or components in a timely manner, or to provide materials and components that meet the Company's quality, quantity or cost requirements, or its inability to obtain substitute materials and components in a timely manner or on terms acceptable to the Company, may harm the Company's ability to manufacture its products. To the extent that the Company is unable to develop and patent its own technology and manufacturing processes, and to the extent that the processes, which its suppliers use to manufacture materials and components, are proprietary, the Company may be unable to obtain comparable materials or components from alternative suppliers, and that could adversely affect its ability to produce commercially viable products.

***The Company anticipates undergoing a period of continuing growth in its business, the scope of its operations and the number of its employees and its failure to manage this growth could cause its results to fluctuate and harm its business.***

The Company anticipates undergoing a period of growth in the scope of its operations and in the number of its employees. The Company may be unable to manage its growth effectively, and its failure to do so could have a material adverse effect on its operating results and cause its results to fluctuate. As part of its growth strategy the Company intends to introduce new products, increase its outsourcing capacity and develop additional customer and distributor relationships. Its expense levels are based, in part, on expected future revenues and the Company is limited in its ability to reduce expenses quickly if for any reason its purchase orders do not meet its expectations in a particular quarter or period. Furthermore, expansion will likely place a strain on its senior management team, key and technical personnel, its

business operations and other resources. The Company's ability to manage growth will depend in part on its ability to continue to enhance its manufacturing and management information systems. It may be difficult to increase manufacturing or outsourcing capacity in a timely fashion if customer demands increase in ways that the Company did not anticipate. Any inability to manage growth could result in shipment delays and cancellation of customer orders.

#### Risk factors related to the Company's target markets

##### ***The Company's markets are exposed to recessionary risk***

The current financial crisis and possible global recession may result in lost or delayed sales orders, as many of the Company's existing and targeted customers may cut back their proposed capital spending in the face of economic uncertainty and limited access to project financing. This would impact the ability of the Company to grow its business, and as a result sales orders may be lower than expected. Any decrease in sales would negatively impact the Company's cash burn and other financial results. Different gas purification markets and different geographies may be impacted to different extents, making it difficult to forecast the likely impact.

##### ***Volatility of Oil and Natural Gas Prices***

The Company's PSA systems represent a significant potential capital cost to the Company's existing and target customers and their ability to purchase the Company's products is dependent upon factors which affect energy industries

The Company's existing and target customers' results of operations and financial condition are dependent on the prices they receive for oil, natural gas and renewable natural gas. Oil and natural gas prices have fluctuated widely during recent years and are determined by local and worldwide supply and demand factors, including actions by the Organization of Petroleum Exporting Countries, weather conditions, the U.S. dollar exchange rate, transportation, competition, and general economic conditions as well as conditions in other oil producing regions, which are beyond the Company's control. Any material decline in oil or natural gas prices could have a material adverse effect on the Company's existing and target customers' operations, financial condition, and the amount they spend on new capital equipment and the development of new technology, which could have a material adverse effect on the Company's existing and target customers' ability to purchase the Company's products. If the shift to heavier crude oils were reversed due to the uneconomic nature of their extraction, such as oil sands extraction, the target markets for the Company's PSA systems could be adversely affected.

In addition, the Company's prospects would be adversely affected should the cost of natural gas were to fall to levels where production of renewable natural gas from raw biogas becomes uneconomic.

##### ***Changes in government policies and regulations could hurt the market for the Company's products.***

The biogas upgrading industry is subject to different government incentives and regulations in various jurisdictions around the world. Any significant change in these incentives or regulations, including a decision to reverse subsidy programs for renewable natural gas production or a decision to subsidize electricity generation rather than renewable natural gas, would adversely impact the Company's ability to sell its PSAs and integrated biogas upgrading plants in those jurisdictions. Furthermore, the inability of its potential customers to obtain a permit, or the inconvenience often associated with the permit process, could harm demand for biogas upgrading plants and, therefore, harm the Company's business.

The expected demand for biogas upgrading plants is driven in part by local pollution regulations and regulatory pressures to reduce greenhouse gas emissions. The Company's business may suffer if these

environmental policies and regulations change and no longer encourage the development and growth of clean power technologies. There can be no guarantee that these laws and regulations will not change. Changes in these laws and regulations could result in reduced demand for biogas upgrading systems. In addition, if current laws and regulations are not kept in force or if further environmental laws and regulations are not adopted in certain jurisdictions, demand for biogas upgrading equipment may be limited.

The demand for QuestAir's refinery related products is driven in part by regulations mandating the reduction of sulphur levels in transportation fuels such as gasoline and diesel. The Company's business may suffer if these environmental policies and regulations change and no longer encourage the production of 'clean' transportation fuels. There can be no guarantee that these laws and regulations will not change.

***The Company's products use flammable fuels that are inherently dangerous substances and could subject the Company to product liabilities.***

The Company's results of operations could be materially harmed by accidents involving either its products or those of other manufacturers, either because the Company faces claims for damages or because demand for its products could suffer and its sales could decline. The Company's products purify hydrogen and methane containing gases. While its PSA systems do not use these fuels in a combustion process, natural gas used to generate hydrogen, biogas and biomethane are flammable fuels that could leak and then combust if ignited by another source. In addition, certain of the Company's customers may experience significant product liability claims. As a supplier of products and systems, the Company faces an inherent business risk of exposure to product liability claims in the event that its products, or the equipment into which its products are incorporated, malfunction and result in personal injury, death or property damage. The Company may be named in product liability claims even if there is no evidence that its systems or components caused the accidents. Product liability claims could result in significant losses as a result of expenses incurred in defending claims or the award of damages. Since the Company's products have not yet gained widespread market acceptance, any accidents involving its systems, or those used to produce purified biomethane or hydrogen could materially impede acceptance of its products.

***Environmental Risks***

All phases of the oil and natural gas business, and of the processing of organic wastes, are subject to environmental regulation pursuant to a variety of Canadian federal, provincial, state and municipal laws and regulations, as well as international conventions (collectively, "Environmental Legislation").

Environmental Legislation imposes, among other things, restrictions, liabilities and obligations in connection with the generation, handling, storage, transportation, treatment and disposal of hazardous substances and waste and in connection with spills, releases and emissions of various substances to the environment. Environmental Legislation also requires that wells, facility sites and other properties associated with oil and natural gas operations be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. In addition, certain types of operations, including exploration and development projects and significant changes to certain existing projects, may require the submission and approval of environmental impact assessments. Compliance with Environmental Legislation can require significant expenditures and failure to comply with Environmental Legislation may result in the imposition of fines, penalties and liability for clean up costs and damages. Changes in Environmental Legislation may require, among other things, reductions in emissions to the air from the Company's existing and target customers' operations and result in increased capital expenditures. Future changes in Environmental Legislation could occur and result in stricter

standards and enforcement, larger fines and liability, and increased capital expenditures and operating costs, which could have a material adverse effect on the Company's existing and target customers' ability to purchase the Company's products.

### **Management's Responsibility for Financial Reporting**

The accompanying financial statements of QuestAir Technologies Inc. and all the information in the 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 judgment. 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.

**(signed) Andrew Hall**

President and Chief Executive Officer

**(signed) Sherry Tryssenaar**

Vice President Finance and Administration & Chief Financial Officer

**To the Shareholders of  
QuestAir Technologies Inc.**

We have audited the balance sheets of **QuestAir Technologies Inc.** as at September 30, 2008 and 2007 and the statements of operations, comprehensive loss and deficit, shareholders' equity and cash flows for each of the years in the two-year period ended September 30, 2008. 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 financial statements present fairly, in all material respects, the financial position of the company as at September 30, 2008 and 2007 and the results of its operations and its cash flows for each of the years in the two-year period ended September 30, 2008 in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

**Chartered Accountants**

Vancouver, British Columbia  
December 3, 2008



# QuestAir Technologies Inc.

Balance Sheets

As At September 30, 2008 and 2007

(expressed in Canadian dollars)

	2008 \$	2007 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	9,265,249	5,726,245
Restricted cash (note 3)	281,005	340,802
Short-term investments	62,048	3,060,447
Accounts receivable - net of allowance for doubtful accounts of \$92,689 (2007 - \$nil)	974,404	1,412,983
Inventories (note 4)	5,214,342	4,376,717
Prepaid expenses	199,269	256,378
	<u>15,996,317</u>	<u>15,173,572</u>
<b>Long-term assets</b>		
Property, plant and equipment (note 5)	1,329,986	1,703,872
Other long-term assets	178,930	175,080
	<u>17,505,233</u>	<u>17,052,524</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 6)	2,896,307	2,791,139
Deferred revenue	4,735,258	4,546,584
Current portion of bank debt (note 7)	443,345	564,306
Current portion of obligation under capital lease (note 8)	105,479	97,822
Derivatives (note 9)	412	75,874
	<u>8,180,801</u>	<u>8,075,725</u>
<b>Long -term liabilities</b>		
Bank debt (note 7)	228,262	356,030
Obligation under capital lease (note 8)	-	97,822
	<u>8,409,063</u>	<u>8,529,577</u>
<b>Shareholders' Equity</b>		
<b>Share capital</b> (note 10)		
Authorized		
Unlimited common shares, voting, no par value		
Unlimited preferred shares, issuable in series, no par value		
<b>Common shares</b>	115,363,615	109,383,859
<b>Contributed surplus</b> (note 10)	8,863,225	6,626,825
<b>Deficit</b>	(115,130,670)	(107,487,737)
	<u>9,096,170</u>	<u>8,522,947</u>
	<u>17,505,233</u>	<u>17,052,524</u>
<b>Commitments and contingencies</b> (note 14)		

Approved by the Board of Directors

\_\_\_\_\_(signed) Andrew Hall Director      \_\_\_\_\_(signed) Denis Connor Director



# QuestAir Technologies Inc.

## Statement of Operations, Comprehensive Loss and Deficit For the years ended September 30, 2008 and 2007

(expressed in Canadian dollars)

	2008	2007
	\$	\$
<b>Revenues</b>	11,432,256	7,012,166
<b>Cost of goods sold</b>	8,030,894	7,007,989
<b>Gross profit</b>	<u>3,401,362</u>	<u>4,177</u>
<b>Operating expenses</b> (note 2)		
Research and development – net (note 12)	3,004,486	4,800,592
General and administration	3,981,456	3,667,755
Sales and marketing	1,796,842	2,117,706
Operations	1,478,150	936,951
Amortization	734,121	850,833
	<u>10,995,055</u>	<u>12,373,837</u>
<b>Loss before undernoted</b>	<u>(7,593,693)</u>	<u>(12,369,660)</u>
<b>Other income (expense)</b>		
Interest income	199,493	522,524
Royalty expense	(632,895)	(160,984)
Other income (expense)	384,162	(409,292)
	<u>(49,240)</u>	<u>(47,752)</u>
<b>Loss and comprehensive loss for the year</b>	(7,642,933)	(12,417,412)
<b>Deficit – Beginning of year</b>	(107,487,737)	(95,045,478)
<b>Unrealized foreign exchange loss on derivatives</b> (note 10)	-	(24,847)
<b>Deficit – End of year</b>	<u>(115,130,670)</u>	<u>(107,487,737)</u>
<b>Basic and diluted loss per share</b> (note 16)	<u>(1.09)</u>	<u>(2.37)</u>

**QuestAir Technologies Inc.**  
**Statements of Shareholders' Equity**  
**For the years ended September 30, 2008 and 2007**

(expressed in Canadian dollars)

	Common shares \$	Contributed surplus \$	Accumulated other comprehensive income (loss) \$	Deficit \$	Total shareholders' equity \$
<b>Balance - September 30, 2006</b>	109,020,202	6,462,772	-	(95,045,478)	20,437,496
Loss and comprehensive loss	-	-	-	(12,417,412)	(12,417,412)
Adjustment to opening balance of unrealized foreign exchange loss on embedded derivatives	-	-	-	(24,847)	(24,847)
Exercise of share options	69,643	-	-	-	69,643
Stock-based compensation allocated to common shares on exercise of share options	294,014	(294,014)	-	-	-
Stock-based compensation on fair value share options	-	458,067	-	-	458,067
<b>Balance - September 30, 2007</b>	109,383,859	6,626,825	-	(107,487,737)	8,522,947
Loss and comprehensive loss	-	-	-	(7,642,933)	(7,642,933)
Issuance of common shares - net of financing costs of \$925,582	5,661,057	-	-	-	5,661,057
Issuance of warrants - net of financing costs of \$339,136	-	2,257,825	-	-	2,257,825
Exercise of share options	143	-	-	-	143
Stock-based compensation allocated to common shares on exercise of share options	318,556	(318,556)	-	-	-
Stock-based compensation on fair value share options	-	297,131	-	-	297,131
<b>Balance - September 30, 2008</b>	115,363,615	8,863,225	-	(115,130,670)	9,096,170

# QuestAir Technologies Inc.

## Statements of Cash Flows

September 30, 2008 and 2007

(expressed in Canadian dollars)

	2008	2007
	\$	\$
<b>Cash flows from operating activities</b>		
Loss for the year	(7,642,933)	(12,417,412)
Items not involving cash		
Amortization	734,121	850,833
Gain on sale of property, plant and equipment	(17,309)	(412)
Unrealized foreign exchange (gain) loss on derivatives	(75,462)	51,027
Non-cash compensation expense	297,131	458,067
Foreign currency loss (gain)	12,240	(32,489)
	<u>(6,692,212)</u>	<u>(11,090,386)</u>
Changes in non-cash operating working capital		
Accounts, grants and funding receivables	438,579	517,638
Inventories	(837,625)	(866,209)
Prepaid expenses	53,259	30,877
Accounts payable and accrued liabilities	105,168	(1,304,932)
Deferred revenue	188,674	2,599,803
	<u>(51,945)</u>	<u>977,177</u>
	<u>(6,744,157)</u>	<u>(10,113,209)</u>
<b>Cash flows from investing activities</b>		
Decrease in short-term investments	3,060,447	7,400,000
Increase in short-term investments	(62,048)	(3,060,447)
Purchase of property, plant and equipment	(364,768)	(426,729)
Government grants and funding related to property, plant and equipment	-	5,434
Proceeds on sale of property, plant and equipment	21,842	9,046
Decrease in restricted cash	59,797	915,552
	<u>2,715,270</u>	<u>4,842,856</u>
<b>Cash flows from financing activities</b>		
Proceeds from financing	9,000,000	-
Share issue cost	(1,081,118)	-
Issuance of common shares on exercise of stock options	143	69,642
Repayment of obligations under capital lease	(102,405)	(127,930)
Term loan advance	344,553	462,760
Repayment of bank debt	(593,282)	(426,674)
	<u>7,567,891</u>	<u>(22,202)</u>
<b>Increase (Decrease) in cash and cash equivalents</b>	<u>3,539,004</u>	<u>(5,292,555)</u>
<b>Cash and cash equivalents – Beginning of year</b>	<u>5,726,245</u>	<u>11,018,800</u>
<b>Cash and cash equivalents – End of year</b>	<u>9,265,249</u>	<u>5,726,245</u>
<b>Supplemental cash flow information</b> (note 17)		

# QuestAir Technologies Inc.

Notes to Financial Statements  
September 30, 2008 and 2007

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(expressed in Canadian dollars)

## 1 Nature of operations

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 purified gases for a wide variety of industries. The Company’s products, which incorporate patented, proprietary technology, primarily target hydrogen and methane purification in a range of existing industrial and energy markets, including oil refinery and biogas processing applications.

The Company has not yet realized profitable operations and has relied on non-operational sources of financing to fund its operations. The Company raised additional capital to finance its operations in fiscal 2008. The Company’s ultimate success and the recoverability of long-lived assets will depend on its ability to successfully execute its business plan.

## 2 Significant accounting policies

### Basis of presentation

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

The Company prepares an income statement using the functional format, other than amortization, which is not allocated to the respective functions, and categorizes operating expenses in the following captions:

- a) Research and development: salaries and benefits of research and development personnel, patent filing costs and other expenses incurred in development programs.
- b) General and administration: salaries and benefits of accounting, human resources and information technology personnel, audit, legal, investor relations, share compensation and other general corporate expenses.
- c) Sales and marketing: salaries and benefits of sales and marketing personnel, sales commissions, advertising and sales related travel costs.
- d) Operations: salaries and benefits of quality assurance, non-development engineering and supply chain personnel, value engineering and process improvement costs.

### 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. Assessment of the valuation of stock-based compensation,

# QuestAir Technologies Inc.

Notes to Financial Statements

September 30, 2008 and 2007

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(expressed in Canadian dollars)

accrued warranty, revenue from long-term contracts, revenue from engineering service contracts and losses related to contracts are significant areas requiring the use of estimates. Actual results could differ from these estimates.

## Cash and cash equivalents

Cash is comprised of unrestricted bank deposits some of which are interest bearing. Cash equivalents consist of money market accounts and term deposits that are readily convertible to known amounts of cash and are held to their original maturities within three months from their date of purchase. They are carried at fair value and are classified as held for trading.

## Short-term investments

The Company's investments consist of term deposits, and are classified as held to maturity for accounting purposes and are carried on the balance sheets at amortized cost using the effective interest method. Investments with maturities of greater than ninety days and less than one year are classified as short-term investments.

## 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 its 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 to be realized on sale. An impairment loss is

# QuestAir Technologies Inc.

Notes to Financial Statements

September 30, 2008 and 2007

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(expressed in Canadian dollars)

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 incurred in the 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 and recorded as a royalty expense.



# QuestAir Technologies Inc.

Notes to Financial Statements  
September 30, 2008 and 2007

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(expressed in Canadian dollars)

## **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 statement of operations, comprehensive loss 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. The effects of forfeitures are accounted for as they occur.

## **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**

### Recognition and Measurement

The company uses the following classifications for its financial instruments:

- a) Short-term liquid investments included in cash and cash equivalents have been classified as held-for-trading and short-term investments have been classified as held-to-maturity.
- b) The Company's accounts receivable are initially measured at fair value and subsequently at amortized cost, using the effective interest method less provisions for impairment.

# QuestAir Technologies Inc.

Notes to Financial Statements  
September 30, 2008 and 2007

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(expressed in Canadian dollars)

- c) The Company's accounts payable and accrued liabilities are initially measured fair value and subsequently at amortized cost, using the effective interest method.
- d) The Company's debt has been classified as other financial liability, and initially measured at fair value and subsequently at amortized cost using the effective interest method.

Financial assets and liabilities classified as held-for-trading are measured at fair value at each reporting period with changes in fair value in subsequent periods included in net earnings. Held-to-maturity assets are initially measured at fair value and subsequently at amortized cost using the effective interest method.

The Company classifies derivative financial instruments which have not been designated as hedges for accounting purposes and embedded derivatives as held-for trading, and values them at fair value each period with changes recorded in other income. The embedded derivatives relate to the foreign exchange component of certain sales contracts which the Company enters into during the regular course of business (note 9 and 10c). The Company does not designate these derivative financial instruments as hedges.

## Disclosures and presentation

CICA Handbook Section 3862 Financial Instruments - Disclosures provides standards for disclosures about financial instruments, including disclosures about fair value and the credit, liquidity and market risks associated with the financial instruments. CICA Handbook Section 3863 Financial Instruments - Presentation establishes standards for presentation of financial instruments and non-financial derivatives. On September 30, 2007, the Company early adopted these Sections. The early adoption of Section 3862 required additional disclosures in the Notes to the financial statements which are contained in note 9.

## Capital disclosures

CICA Handbook Section 1535 - Capital Disclosures requires an entity to disclose information to enable users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. On September 30, 2007, the Company elected to early adopt 1535 resulting in additional disclosures contained in note 10.

## Financing charges

Financing charges, which reflect the cost to obtain new debt financing, are expensed as incurred. Financing charges, which reflect the cost to obtain new equity financing, are deducted from net proceeds as incurred.

# QuestAir Technologies Inc.

Notes to Financial Statements  
September 30, 2008 and 2007

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(expressed in Canadian dollars)

## **Comparative amounts**

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

## **Future accounting changes**

The CICA issued Section 3031, Inventories, which supersedes the previously issued standard on inventory and introduces significant changes to the measurement and disclosure of inventory. The measurement changes include: the elimination of LIFO, and the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. Disclosures of inventories have also been enhanced. Inventory policies, carrying amounts, amounts recognized as an expense, write-downs and the reversals of write-downs are required to be disclosed. This new standard comes into effect for fiscal years beginning on or after January 1, 2008; accordingly the Company will adopt this new standard in fiscal 2009. The Company is assessing the impact this standard will have on its financial statements.

The CICA issued Section 3064, Goodwill and Intangible Assets, which establish standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets (including internally developed intangible assets). These recommendations are effective for the Company beginning October 1, 2008; accordingly the Company will adopt this new standard in fiscal 2009. Goodwill and intangible assets that are not assets as defined by GAAP will be derecognized and charged to the equity of the Company at that date. The Company is assessing the impact this standard will have on its financial statements.

The CICA revised section 1400, General Standards of Financial Statement Presentation, which requires management to make an assessment of, and disclose material uncertainties related to, the ability of an entity to continue as a going concern. This new standard comes into effect for fiscal years beginning on or after January 1, 2008; accordingly QuestAir will adopt this new standard in fiscal 2009. The Company is assessing the impact this standard will have on its financial statements.

On February 13, 2008, the Canadian Accounting Standards Board confirmed that International Financial Reporting Standards will replace Canada's current generally accepted accounting principles for publicly accountable profit-oriented enterprises for interim and annual financial statements effective January 1, 2011. The Company is presently considering the effect these standards will have on its financial statements.

# QuestAir Technologies Inc.

Notes to Financial Statements

September 30, 2008 and 2007

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(expressed in Canadian dollars)

## 3 Restricted cash

During 2008, the Company was required to deposit cash with Comerica Bank as collateral in order 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 July 20, 2009. Restricted cash at September 30, 2008 of \$281,005 (2007 - \$340,802) relates to letters of credit of \$281,005 (2007 - \$340,802).

## 4 Inventories

	2008 \$	2007 \$
Raw materials and supplies	823,006	895,988
Work-in-progress	1,577,912	2,317,754
Finished goods	2,813,424	1,162,975
	<u>5,214,342</u>	<u>4,376,717</u>

## 5 Property, plant and equipment

	2008		
	Cost \$	Accumulated amortization \$	Net \$
Lab and warehouse equipment	2,526,138	2,243,341	282,797
Manufacturing equipment	1,934,880	1,920,557	14,323
Leasehold improvements	1,727,241	1,241,311	485,930
Computer equipment	1,403,317	1,139,308	264,009
Test equipment	1,273,457	1,003,762	269,695
Office equipment	263,434	257,213	6,221
Furniture and fixtures	165,979	158,968	7,011
	<u>9,294,446</u>	<u>7,964,460</u>	<u>1,329,986</u>

# QuestAir Technologies Inc.

Notes to Financial Statements  
September 30, 2008 and 2007

(expressed in Canadian dollars)

	<b>2007</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	<b>\$</b>	<b>amortization</b>	<b>\$</b>
		<b>\$</b>	
Lab and warehouse equipment	2,468,956	2,033,946	435,010
Manufacturing equipment	1,920,074	1,896,995	23,079
Leasehold improvements	2,369,348	1,856,096	513,252
Computer equipment	2,262,737	1,848,571	414,166
Test equipment	3,159,623	2,856,693	302,930
Office equipment	266,434	257,573	8,861
Furniture and fixtures	207,805	201,231	6,574
	<u>12,654,977</u>	<u>10,951,105</u>	<u>1,703,872</u>

As at September 30, 2008, assets under capital lease with a cost of \$357,878 (2007 - \$356,065) and accumulated amortization of \$178,576 (2007 - \$57,860) are included in property, plant and equipment. Amortization expense for assets under capital lease recorded in the statement of operations, comprehensive loss and deficit for the year ended September 30, 2008 was \$120,716 (2007 - \$57,860).

## 6 Accounts payable and accrued liabilities

	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
Trades payable	585,805	1,256,234
Wages and benefits	971,825	723,322
Royalty payable	756,476	218,307
Warranty provision	432,626	473,475
Accounting and legal costs	107,352	119,000
Taxes payable (GST, PST)	42,223	801
	<u>2,896,307</u>	<u>2,791,139</u>

## 7 Bank debt

In April 2005, the Company signed a credit facilities agreement with Comerica Bank. This agreement was amended and restated in June 2008 as part of the annual renewal of these facilities (Tranche 4). The amended credit facilities include a US\$1 million accounts receivable line of credit and a US\$1 million term loan to finance equipment purchases, in addition to amounts outstanding under prior term loan agreements. Both facilities are secured by the assets of the Company, with certain exceptions. Under the terms of the agreement, the Company must comply with financial covenants and certain other business terms.

# QuestAir Technologies Inc.

Notes to Financial Statements  
September 30, 2008 and 2007

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(expressed in Canadian dollars)

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 1.75% above the Prime Rate. Interest is payable monthly, and the line of credit is renewable annually. As at September 30, 2008, no amounts were drawn against this facility.

The variable interest rate of the Tranche 4 term loan is 1.75% above the Prime Rate compared to 0.75% above the Prime Rate on the prior term loans. Interest on Tranche 1 is initially payable monthly with 36 equal payments of principal plus interest payable beginning October 22, 2005. Interest on Tranche 2, 3 and 4 is initially payable monthly with 30 equal payments of principal plus interest payable beginning February 1, 2007, 2008 and 2009 respectively. As at September 30, 2008, the Company had drawn \$671,607 (2007 - \$920,336) on the term loans net of repayments.

	<b>2008</b>	<b>2007</b>
	\$	\$
Current portion of bank debt	443,345	564,306
Long-term portion of bank debt	228,262	356,030
	<u>671,607</u>	<u>920,336</u>

Accrued interest payable as at September 30, 2008 was \$1,939 (2007 - \$1,979) and is included in accounts payable and accrued liabilities. The effective interest rate of the term loans was 6.25% (2007 - 7.05%) for the year ended September 30, 2008. Total interest expense was \$55,370 (2007 - \$58,599) for the year ended September 30, 2008. Draws can be made against the Tranche 4 term loan, to a maximum of US\$1 million, prior to June 19, 2009. As at September 30, 2008, \$190,924 had been drawn against the Tranche 4 term loan.

## 8 Obligations under capital lease

In April 2007, the Company entered into a computer software license under a capital lease which expires in 2009 and bears an implied annual interest rate of 8.1%. Interest paid during 2008 related to obligations under capital lease was \$11,526 (2007 - \$nil) and \$5,813 (2007 - \$5,753) was accrued in 2008. At September 30, 2008, future minimum lease payments under capital leases are \$105,479 (2007 - \$195,644).

## 9 Financial instruments

On October 1, 2006, the Company adopted section 3855, giving rise to the initial recognition of unrealized losses on embedded derivatives. These amounts have been calculated and labeled as transitional balances and have been recognized in the opening retained earnings of the Company.



# QuestAir Technologies Inc.

Notes to Financial Statements

September 30, 2008 and 2007

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(expressed in Canadian dollars)

The Company marks to market all financial derivative instruments outstanding at the end of the reporting period, with the unrealized gain/loss charged to other expense with a corresponding offset amount recorded in the balance sheet. Included in the loss for the year ended September 30, 2008 is a \$75,462 (2007 – \$51,027 loss) unrealized foreign exchange gain on such embedded derivatives. This gain was determined based on future billing under the sales contract, exchange rates prevailing at the time the contract was entered into, and exchange rates prevailing at September 30, 2008.

The following table summarizes the carrying value of the Company's financial instruments:

	2008	2007
	\$	\$
Held for trading (cash and cash equivalents and restricted cash)	9,546,254	6,067,047
Held to maturity (short term investments)	62,048	3,060,447
Loans and receivables	974,404	1,412,983
Other financial liabilities	3,673,393	3,907,119

The carrying amount of short-term financial instruments, less provisions for impairment if applicable, is used to estimate the fair value of such instruments. The Company's debt bears a variable interest rate, and therefore its carrying value approximates its fair value.

Interest income and other gains and losses from "held for trading" and "held to maturity" financial assets are recognized in interest income. Interest income, expense and gains and losses from loans, receivables and other financial liabilities are recognized in other income (expense). The following table summarizes interest income and expense under the effective interest method for the year ended September 30, 2008:

	2008	2007
	\$	\$
Interest income from held for trading financial assets	159,877	337,102
Interest income from held to maturity financial assets	15,925	184,044
Interest expense from other financial liabilities	66,895	64,352

## Risks

The Company's activities expose it to various risks, including credit risk, market risks such as foreign exchange risk and interest rate risk, and liquidity risk. The Company's risk management activities are designed to mitigating possible adverse effects on the Company's performance, having regard for the size and scope of the Company's operations, with a primary focus on preservation of capital. Risk management activities are managed by the finance and accounting department.

The following analysis will provide a measurement of risks as at September 30, 2008.

# QuestAir Technologies Inc.

Notes to Financial Statements  
September 30, 2008 and 2007

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(expressed in Canadian dollars)

i) Credit risk

Credit risk is the risk that the Company will incur a loss due to the failure by its customers or other parties to meet their contractual obligations. Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents, restricted cash and accounts receivable. The Company limits its exposure to credit risk by placing its cash and cash equivalents, restricted cash and short-term investments with high credit quality financial institutions. Given the current economic environment, the Company recently re-assessed the credit quality of the financial institutions it deals with, and determined that they continue to be high credit quality institutions.

Credit risk is limited by the structure of the Company's sales contracts. Typically, milestone payments valued at 80% of the contract value are collected prior to shipment. Further, under its standard contract terms, the Company retains title to all equipment until final payment is received, which provides the Company with further protection in respect of its accounts receivable. Given the current economic environment, accounts receivable invoices have been reviewed for each customer at year end for collectability and an allowance for doubtful accounts has been estimated. At September 30, 2008, the allowance for doubtful accounts balance of \$92,689 (2007 - \$nil) relates to outstanding invoices from one customer that is experiencing financial difficulties. In addition, we recorded a bad debt expense of \$8,629 during the year ended September 30, 2008. There had not been any write-offs related to bad debt for the previous 5 fiscal years.

At September 30, 2008, 28.5% (2007 - 9.5%) of trades receivable were outstanding for more than 90 days, 27.4% (2007 - 56.1%) were outstanding for between 30 and 90 days and the remaining 44.1% (2007 - 34.4%) were outstanding less than 30 days. Trades receivables are considered past due based on the contract terms agreed to with a customer. As noted above, aged receivables that are past due are not considered impaired unless customer specific information indicates otherwise.

ii) Foreign exchange risk

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Company is exposed to foreign exchange risk on its cash, cash equivalents, restricted cash, short-term investment and accounts receivable balances, as well as its obligations under capital leases and accounts payable.

Predominantly all of the Company's sales are in United States dollars or Euros and are converted to Canadian dollars at the time of revenue recognition. For the year ended September 30, 2008, the Canadian value of United States dollar denominated sales was \$9,295,642 (2007 - \$6,008,402) and Euro denominated sales was \$1,182,479 (2007 - \$763,948). The Company does not hold or issue financial instruments to manage its exposure to currency rate fluctuations relating to sales; however it does maintain cash

# QuestAir Technologies Inc.

Notes to Financial Statements

September 30, 2008 and 2007

(expressed in Canadian dollars)

balances in foreign currencies sufficient to meet obligations to foreign suppliers, in effect providing a natural hedge. Periodically, excess balances of foreign currency are converted to local currency to meet Canadian dollar cash requirements.

At September 30, 2008, the Canadian/US foreign exchange rate was 0.9397 (2007-1.0052) and the Canadian/Euro rate was 0.6676 (2007 - 0.7049). Assuming that all other variables remain constant, an increase of \$0.10 in the Canadian dollar would have following impact on the ending balances of certain balance sheet items at September 30, 2007 and 2008, with the net foreign exchange gain or loss directly impacting net loss for fiscal 2007 and 2008.

(expressed in Canadian dollars)	Net change in US\$ balances \$	Net change in Euro balances \$	2008 Total net change in foreign currency balances \$
<b>Financial assets</b>			
Cash and cash equivalents	(83,960)	(22,829)	(106,789)
Short-term investments	(142,612)	-	(142,612)
Trade accounts receivable	(56,854)	(30,477)	(87,331)
<b>Financial liabilities</b>			
Accounts payable and accrued liabilities	15,346	126	15,471
Obligations under capital lease	10,145	-	10,145
<b>Net foreign exchange loss</b>	<b>(257,935)</b>	<b>(53,180)</b>	<b>(311,115)</b>

  

(expressed in Canadian dollars)	Net change in US\$ balances \$	Net change in Euro balances \$	2007 Total net change in foreign currency balances \$
<b>Financial assets</b>			
Cash and cash equivalents	(52,020)	(154,296)	(206,316)
Short-term investments	(202,519)	-	(202,519)
Trade accounts receivable	(112,781)	(3,430)	(116,211)
<b>Financial liabilities</b>			
Accounts payable and accrued liabilities	49,997	2,424	52,421
Obligations under capital lease	17,702	-	17,702
<b>Net foreign exchange loss</b>	<b>(299,622)</b>	<b>(155,302)</b>	<b>(454,924)</b>

# QuestAir Technologies Inc.

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iii) Interest risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Company is exposed to interest risk on its bank debt for which the interest rates charged fluctuate based on the bank prime rate. Bank debt at September 30, 2008 is \$671,607 (2007 - \$920,336). Interest is compounded daily at prime plus 1.75% on the Tranche 4 term loan, and at prime plus 0.75% on all prior term loans. If the interest rate on the bank debt had been 50-basis points higher (lower), related to the bank debt outstanding during fiscal 2008, net loss would have been \$471 (2007 - \$445) higher (lower).

iv) Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its obligations as they fall due. The following are the contractual maturities of financial liabilities as at September 30, 2008:

	<b>Contractual cash flows</b>	<b>0 to 12 months</b>	<b>12 to 24 months</b>	<b>After 24 months</b>
	\$	\$	\$	\$
<b>Financial liabilities</b>				
Accounts payable and accrued liabilities	2,896,307	2,896,307	-	-
Bank debt	671,607	443,345	156,347	71,915
Obligation under capital lease	105,479	105,479	-	-
	<u>3,673,393</u>	<u>3,445,131</u>	<u>156,347</u>	<u>71,915</u>

It is the Company's intention to meet these obligations through the collection of accounts receivable and the receipt of future progress payments on amounts not yet invoiced, as well as from current cash, cash equivalents and short-term investment resources. In addition, the Company has available lines of credit and term loans of US\$1.8 million at September 30, 2008.

## 10 Shareholder's equity

a) Common shares – issued and outstanding

During the year ended September 30, 2008, the Company completed an equity offering issuing 60,000,000 subscription receipts for gross proceeds of \$9,000,000. Each subscription receipt was exchanged for one common share of the Company stock and one common share purchase warrant. The Company subsequently consolidated its issued and outstanding share capital on a 1 new share for 10 old shares basis. After giving effect to the share consolidation, each whole warrant will entitle the holder to acquire one additional common share at a

# QuestAir Technologies Inc.

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price of \$2.15 per share until May 13, 2010. A fair value of \$2,413,361 was recognized by the Company as the proceeds for the warrants. Total share issuance costs for the financing was \$1,264,718 including non cash costs of \$183,600, of which \$925,582 was allocated to common shares and \$339,136 was allocated to warrants.

The fair value of warrants was estimated as at the date the equity offering was priced, using the Black-Scholes option-pricing model with the following weighted-average assumptions:

Dividend yield	0.0%
Expected volatility	65%
Risk-free interest rate	2.8%
Expected average warrant term (years)	2.00

After giving effect to the equity offering and share consolidation, authorized share capital consists of an unlimited number of common shares, of which 11,268,318 (2007 – 5,254,002) common shares were issued and outstanding as of September 30, 2008. During the year ended September 30, 2008, 14,316 (2007 – 14,742) common shares were issued on exercise of share options. An unlimited number of preferred shares are authorized, none of which are issued. The basic and diluted earnings per share have been adjusted retroactively for all periods presented to reflect the common share consolidation.

## b) Share purchase warrants - issued and outstanding

During the year 6,180,000 (2007 – nil) warrants were issued and remain outstanding at September 30, 2008. 6,000,000 were issued on exchange of subscription receipts, with each warrant entitling the holder to acquire one additional common share at a price of \$2.15 per share until May 13, 2010. The remaining 180,000 warrants were issued to Underwriters and entitle the holder to acquire one common share at a price of \$1.50 per share until May 13, 2010.

19,231 transferable share purchase warrants, issued as part of the agreement with the Canadian Federal Minister of Industry under the Technology Partnerships Canada (“TPC”) Program expired unexercised during the year.

## c) Contributed surplus

During the year ended September 30, 2008 \$297,131 (2007 - \$458,067) stock-based compensation on share options issued to employees under the fair value method was recorded in contributed surplus. As noted above, a fair value of \$2,074,225 was recognized by the Company as proceeds for the warrants net of financing costs of

# QuestAir Technologies Inc.

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(expressed in Canadian dollars)

\$339,136, which is included in the balance of contributed surplus as at September 30, 2008.

d) Deficit

Effective October 1, 2006, the Company adopted new valuation principles required for financial instruments. In accordance with CICA Handbook Section 3855 Financial Instruments – Recognition and Measurement, the difference between the previous carrying amount and fair value of derivatives other than those that are designated and effective hedging items are recognized as an adjustment to the balance of retained earnings at the beginning of the fiscal year in which this section is initially applied. An adjustment to retained earnings of \$24,847 was made to reflect the difference between the carrying amount (being zero) and the fair value of embedded derivatives in sales contracts at September 30, 2006. (Also see note 9)

e) Comprehensive loss

Comprehensive loss is the decrease in equity from sources other than owners and is comprised of net loss and other revenues, expenses, gains, and losses that, pursuant to Canadian GAAP, are excluded from net loss. The Company had no other comprehensive gains or losses during the year, therefore the comprehensive loss equals net loss of \$7,642,933 (2007 - \$12,417,412) for the year ended September 30, 2008.

f) Capital management

As an emerging developer, manufacturer and supplier of PSA systems, the Company is a net consumer of cash with limited access to debt financing. The majority of its capital is generated through the sale of shares. Additional capital resources consist of secured debt.

The Company's objective when managing capital is to safeguard its ability to continue as a going concern in order to provide return to shareholders and benefits for other stakeholders. In order to maintain or adjust its capital structure, the Company may issue new shares or secure long-term debt facilities. The Company does not pay dividends.

Total capital is calculated as follows:

Unaudited	2008	2007
	\$	\$
Bank debt	671,607	920,336
Equity	9,096,170	8,522,947
	<u>9,767,777</u>	<u>9,443,283</u>

The Company does not use financial ratios to manage capital, and it is not subject to any externally imposed capital requirements.



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## 11 Share Options

The Company has issued stock options under two different stock-based incentive plans. The 2004 Stock Option Plan (“2004 Plan”) only allowed for the issuance of stock options. On February 6, 2007, Shareholders approved the adoption of the 2006 Omnibus Plan (“2006 Plan”), which allows for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards and other stock-based awards. Under the 2006 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. After the equity offering was completed in June 2008, the maximum number of common shares available for issuance under all stock-based compensation arrangements increased to 1,126,831.

Under the terms of the 2006 Plan, stock options are granted with an exercise price not less than the volume weighted average trading price of the common shares for the five trading days prior to the date of grant. Stock options generally vest quarterly over four years and are exercisable for seven years from the date of grant. During the year ended September 30, 2008 172,110 (2007 -28,156) options were issued. Included were 144,860 options, vesting over two years and exercisable for five years, issued to non-executive employees. At September 30, 2008 736,839 (2007- 100,256) common shares are available for issuance pursuant to awards made under the 2006 Plan. No other form of stock-based awards have been issued under the 2006 Plan as at September 30, 2008.

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:

	<u>2008</u>	<u>2007</u>
Dividend yield	0%	0%
Expected volatility	70%	52%
Risk-free interest rate	3.33%	4.27%
Expected life of options	3 years	5 years

Share option activity since September 30, 2006 is presented below:

# QuestAir Technologies Inc.

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	<b>Options</b>	<b>Weighted average exercise price \$</b>
Outstanding – September 30, 2006 (341,360 share options exercisable)	493,706	13.39
Granted	28,156	10.79
Exercised	(14,742)	4.72
Forfeited	(30,328)	18.03
Outstanding – September 30, 2007 (381,584 share options exercisable)	476,792	13.21
Granted	172,110	1.52
Exercised	(14,316)	0.01
Forfeited	(273,652)	14.44
Outstanding – September 30, 2008 (222,531 share options exercisable)	360,934	8.13

Exercise price range \$	Number of stock options outstanding	Options outstanding – September 30, 2008		Options exercisable – September 30, 2008	
		Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number of stock options exercisable	Weighted average exercise price \$
0.01	1,000	0.13	0.01	1,000	0.01
0.73 – 2.40	156,600	5.93	1.50	53,110	1.67
4.60 – 6.90	9,679	5.72	6.46	3,921	6.61
9.00 – 11.90	64,011	2.17	9.75	59,029	9.82
12.00 – 13.90	51,549	6.75	12.60	27,675	12.88
16.20 – 17.50	78,095	1.20	17.44	77,796	17.44
	360,934	4.33	8.13	222,531	10.82

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 years ended September 30, 2008 and 2007. In 2008, the Company issued 172,110 (2007 – 28,156) 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 \$1.52 (2007 - \$10.79) and a weighted average fair value of \$0.70 (2007 - \$6.07). During 2008, \$297,131 (2007 - \$458,067) of stock compensation expense has been charged to the statement of operations, comprehensive loss and deficit related to the vesting of stock option awards.

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## 12 Research and development

	2008 \$	2007 \$
Research and development costs	3,004,486	5,175,521
Government grants	-	(374,929)
	<u>3,004,486</u>	<u>4,800,592</u>

## 13 Income taxes

### a) Effective tax rate

Income tax expense (recovery) differs from the amount that would be computed by applying the combined federal and provincial statutory income tax rates of 31.905% (2007 – 34.12%) to income before income taxes. The reasons for the differences are as follows:

	2008 \$	2007 \$
Computed tax recovery	(2,438,000)	(4,237,000)
Increase (decrease) resulting from		
Permanent and other differences	26,000	33,000
Book to tax adjustments	(58,000)	77,000
Stock based compensation	95,000	156,000
Change in future income tax rates	3,833,000	743,000
Change in valuation allowance	(1,458,000)	3,228,000
	<u>-</u>	<u>-</u>

### b) Future tax assets and liabilities

	2008 \$	2007 \$
Non-capital loss carry-forwards	11,433,000	13,242,000
Scientific research and experimental development expenses	6,072,000	6,818,000
Non-refundable provincial tax credits	3,526,000	3,393,000
Share issuance costs	550,000	684,000
Reserves	1,370,000	1,531,000
Property, plant and equipment	1,328,000	1,381,000
Total future tax assets before valuation allowance	24,279,000	27,049,000
Valuation allowance	(24,279,000)	(27,049,000)
Net future tax asset	<u>-</u>	<u>-</u>

# QuestAir Technologies Inc.

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(expressed in Canadian dollars)

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 is dependent 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 \$43,971,000, which are available to reduce taxable income of future years, the benefit of which has not been recorded in the accounts, and which expire as follows:

	\$
2009	3,965,000
2010	8,379,000
2014	4,897,000
2015	5,885,000
2026	6,898,000
2027	7,229,000
2028	6,718,000
	<u>43,971,000</u>

The Company has scientific research and experimental development expenses of \$23,355,000 (2007 - \$22,371,000) which are available to be carried forward indefinitely and deducted against future taxable income otherwise calculated.

- c) As of September 30, 2008, the Company also has investment tax credits of approximately \$8,695,000 (2007 - \$8,357,000) available to offset future Canadian federal and provincial income taxes payable. The investment tax credits began to expire in 2007. The potential benefit of the investment tax credit has not been recognized in the accounts.

## 14 Commitments and contingencies

- a) Leases

At September 30, 2008, the Company is committed to make the following minimum operating lease payments related to premises and office equipment:

	\$
2009	350,814
2010	340,734
2011	337,636
	<u>1,029,184</u>

# QuestAir Technologies Inc.

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(expressed in Canadian dollars)

b) Letters of Credit

During 2008, 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, 2008, \$281,005 (2007 - \$340,802) of these letters of credit are outstanding with varying expiry dates extending to July 20, 2009.

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 ("FCPSA") and Gas Management systems ("GMS").

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

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

- i. the issuance of 19,230 transferable warrants convertible into common shares at a strike price of \$38.80, exercisable for a term of five years (which warrants expired unexercised), and
- ii. repayable contributions to the Minister during the royalty period based on 1.165% of gross business revenues.

During the year ended September 30, 2008, the Company entered into an Amendment Agreement with the Canadian Federal Minister of Industry to amend the TPC contribution agreement in respect of the Company's FCPSA and GMS development programs. The Amendment Agreement:

- iii. deleted certain milestones related to the GMS program
- iv. extended certain milestones related to the FCPSA program, such that the work phase of the program will end on September 30, 2008
- v. reduced the Minister's contribution limit towards eligible project costs to \$8.14 million, being the amount received thus far by the Company
- vi. reduced the ceiling on the conditional repayments under the agreement to \$18.8 million and extended the date by which the royalty period will end by 12 months to September 30, 2022, and
- vii. provided for an unconditional, one-time royalty payment of \$0.5 million to be paid on or before November 28, 2008.

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Cumulative repayments of \$169,744 (2007 - \$88,052) have been made to September 30, 2008. Any amounts ultimately determined to be repayable are accrued as a liability when the project revenues are known and reasonably estimable and recorded as royalty expense. As of September 30, 2008, \$259,797 (2007 - \$210,468) has been accrued as a liability (in addition to the one-time royalty payment noted above).

### *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 \$56,347 (2006 - \$47,651) have been made to September 30, 2008. Any amounts ultimately determined to be repayable are accrued as a liability when the project revenues are known and reasonably estimable and recorded as royalty expense. As of September 30, 2008, \$389 (2007 - \$7,839) 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. Cumulative repayments of \$4,338 (2007 - \$nil) have been made to September 30, 2008. Any amounts ultimately determined to be repayable are accrued as a liability when the project revenues are



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known and reasonably estimable and recorded as royalty expense. As of September 30, 2008, \$1,253 (2007 - \$nil) has been accrued as a liability.

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 and recorded as royalty expense. To date, no such project revenue has been recorded.

e) 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 by-laws 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.

f) Severance and termination benefits

The Company incurred severance costs and termination benefits of \$955,080 during the year ended September 30, 2008 related to the termination of employees and the restructuring of its operations, of which \$494,018 has been paid and \$461,062 is payable prior to the end of fiscal 2009. Severance costs and termination benefits are included in general and administration expenses.

## 15 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:

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	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
Revenue		
United States	8,623,291	4,783,197
Europe	1,848,863	1,654,977
South America	610,940	-
Asia	342,762	447,220
Canada	6,400	126,772
	<hr/>	<hr/>
	11,432,256	7,012,166
	<hr/>	<hr/>

Summarized revenue by stream is as follows:

	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
Gas purification systems	7,757,981	6,322,595
Engineering service contracts	3,674,275	689,571
	<hr/>	<hr/>
	11,432,256	7,012,166
	<hr/>	<hr/>

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

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

	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
Customer A	4,228,465	2,573,252
Customer B	2,978,156	-
Customer C	-	2,315,727

## 16 Loss per share

Loss per share is calculated using the weighted average number of common shares outstanding for the year of 7,019,409 (2007 – 5,247,331). Outstanding share options and warrants to purchase common shares were not included in the computation of diluted loss per share as their impact are anti-dilutive.

# QuestAir Technologies Inc.

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## 17 Supplemental cash flow information

	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
<b>Supplemental cash flow information</b>		
Cash paid for interest	79,057	60,422
Cash received for interest	229,423	601,312
<b>Non-cash operating, investing and financing activities</b>		
Issuance of common shares on exercise of stock options	143	294,014