

Xebec Adsorption Inc.

Consolidated Financial Statements
December 31, 2014 and 2013
(expressed in Canadian dollars)



April 29, 2015

Independent Auditor's Report

To the Shareholders of Xebec Adsorption Inc.

We have audited the accompanying consolidated financial statements of Xebec Adsorption Inc. and its subsidiaries, which comprise the consolidated statements of financial position as at December 31, 2014 and 2013 and the consolidated statements of earnings, comprehensive income, changes in equity and cash flows for the years then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

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

Auditor's responsibility

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

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

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

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



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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Xebec Adsorption Inc. and its subsidiaries as at December 31, 2014 and 2013 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP¹

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

Xebec Adsorption Inc.
Consolidated Statements of Financial Position
As at December 31, 2014 and 2013

(expressed in Canadian dollars)

	2014 \$	2013 \$
Assets		
Current assets		
Cash	1,008,421	2,835,051
Restricted cash (note 6)	221,930	
Trade and other receivables (note 7)	2,681,311	2,915,700
Inventories (note 8)	1,669,350	1,539,180
Current portion of balance of sale (note 15(b))	-	300,000
Investment tax credits receivable	50,000	137,760
Other current assets	396,241	559,001
Total current assets	6,027,253	8,286,692
Non-current assets		
Balance of sale (note 15b))	-	200,000
Property, plant and equipment (note 9)	347,845	310,576
Intangible assets (note 10)	919,297	809,513
Goodwill (note 10)	142,616	142,616
Total non-current assets	1,409,758	1,462,705
Total assets	7,437,011	9,749,397
Liabilities		
Current liabilities		
Bank loan (note 11)	136,437	370,000
Trade and other payables (note 12)	3,491,897	3,429,420
Accrued liabilities	723,890	805,563
Deferred revenue (note 13)	815,010	1,342,794
Current portion of long-term debt (note 15a))	50,475	67,176
Current portion of government royalty program obligation (notes 15c) and 30)	762,825	259,636
Current portion of provisions (note 14)	236,365	489,742
Total current liabilities	6,216,899	6,764,331
Non-current liabilities		
Long-term debt (note 15a))	-	50,476
Government royalty program obligation (note 15c) and 30)	-	586,825
Government assistance	12,083	17,083
Deferred rent	85,748	59,364
Provisions (note 14)	192,990	312,330
Total non-current liabilities	290,821	1,026,078
Total liabilities	6,507,720	7,790,409
Equity		
Equity attributable to shareholders of the Company		
Share capital (note 16)	19,732,623	19,732,623
Contributed surplus	2,460,146	2,388,063
Accumulated other comprehensive loss	(606,685)	(313,486)
Deficit	(20,914,588)	(20,131,974)
	671,496	1,675,226
Non-controlling interest	257,795	283,762
Total equity	929,291	1,958,988
Total liabilities and equity	7,437,011	9,749,397

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

Approved by the Board of Directors

(signed) Kurt Sorschak Director

(signed) William Beckett Director

Xebec Adsorption Inc.

Consolidated Statements of Earnings (Loss)

For the years ended December 31, 2014 and 2013

(expressed in Canadian dollars)

	2014 \$	2013 \$
Revenue	14,368,409	11,311,443
Cost of goods sold	<u>9,490,081</u>	<u>9,686,336</u>
Gross margin	<u>4,878,328</u>	<u>1,625,107</u>
Research and development expenses (note 19)	224,541	17,403
Selling and administrative expenses	5,549,345	5,869,232
Foreign exchange gain	(216,804)	(295,102)
Gain on disposal of assets (note 5)	<u>-</u>	<u>(4,497,610)</u>
	<u>5,557,082</u>	<u>1,093,923</u>
Operating income (loss)	<u>(678,754)</u>	<u>531,184</u>
Finance income	(23,562)	(70,944)
Finance expenses (note 20)	<u>163,985</u>	<u>197,109</u>
Finance costs – net	<u>140,423</u>	<u>126,165</u>
Net earnings (loss) for the year	<u>(819,177)</u>	<u>405,019</u>
Earnings (loss) attributable to:		
Shareholders of the Company	(782,614)	396,892
Non-controlling interest	<u>(36,563)</u>	<u>8,127</u>
	<u>(819,177)</u>	<u>405,019</u>
Earnings (loss) per share		
Basic (note 16)	(0.02)	0.01
Diluted (note 16)	<u>(0.02)</u>	<u>0.01</u>

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

Xebec Adsorption Inc.

Consolidated Statements of Comprehensive Income (Loss)

For the years ended December 31, 2014 and 2013

(expressed in Canadian dollars)

	2014	2013
	\$	\$
Net earnings (loss) for the year	(819,177)	405,019
Other comprehensive income (loss)		
Cumulative translation adjustment	(282,603)	(254,853)
Comprehensive income (loss) for the year	<u>(1,101,780)</u>	<u>150,166</u>
Attributable to:		
Shareholders of the Company	(1,075,813)	132,276
Non-controlling interest	(25,967)	17,890
	<u>(1,101,780)</u>	<u>150,166</u>

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

Xebec Adsorption Inc.

Consolidated Statements of Changes in Equity For the years ended December 31, 2014 and 2013

(expressed in Canadian dollars)

	Number		Amount						
	Common shares	Warrants	Share capital – Common shares and warrants \$	Contributed surplus \$	Accumulated other comprehensive income (loss) \$	Deficit \$	Equity attributable to the shareholders of the Company \$	Non-controlling interest \$	Total \$
Balance – January 1, 2013	39,363,867	10,091,886	19,732,623	2,316,580	(48,870)	(20,528,866)	1,471,467	265,872	1,737,339
Net earnings for the year	-	-	-	-	-	396,892	396,892	8,127	405,019
Other comprehensive income (loss)	-	-	-	-	(264,616)	-	(264,616)	9,763	(254,853)
Comprehensive income (loss) for the year	-	-	-	-	(264,616)	396,892	132,276	17,890	150,166
Stock-based compensation expense (note 17)	-	-	-	71,483	-	-	71,483	-	71,483
Balance – December 31, 2013	39,363,867	10,091,886	19,732,623	2,388,063	(313,486)	(20,131,974)	1,675,226	283,762	1,958,988
Balance – January 1, 2014	39,363,867	10,091,886	19,732,623	2,388,063	(313,486)	(20,131,974)	1,675,226	238,762	1,958,988
Net loss for the year	-	-	-	-	-	(782,614)	(782,614)	(36,563)	(819,177)
Other comprehensive income (loss)	-	-	-	-	(293,199)	-	(293,199)	10,596	(282,603)
Comprehensive loss for the year	-	-	-	-	(293,199)	(782,614)	(1,075,813)	(25,967)	(1,101,780)
Stock-based compensation expense (note 17)	-	-	-	72,083	-	-	72,083	-	72,083
Balance – December 31, 2014	39,363,867	10,091,886	19,732,623	2,460,146	(606,685)	(20,914,588)	671,496	257,795	929,291

Accumulated other comprehensive income (loss) relates solely to cumulative translation adjustments.

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

Xebec Adsorption Inc.

Consolidated Statements of Cash Flows

For the years ended December 31, 2014 and 2013

(expressed in Canadian dollars)

	2014 \$	2013 \$
Cash flows from		
Operating activities		
Net earnings (loss) for the year	(819,177)	405,019
Items not affecting cash		
Amortization of property, plant and equipment	96,231	93,438
Amortization of intangible assets	199,295	169,268
Impairment of inventories	-	475,013
Gain on disposal of assets (note 5)	-	(4,497,610)
Gain on debt forgiveness	(187,481)	(117,619)
Government assistance	(5,000)	(5,000)
Accretion and revaluation of government royalty program obligation	34,364	65,649
Stock-based compensation expense	72,083	71,483
Deferred rent	26,384	26,384
	<u>(583,301)</u>	<u>(3,313,975)</u>
Change in non-cash working capital balances related to operations (note 23)	(377,668)	470,408
	<u>(960,969)</u>	<u>(2,843,567)</u>
Investing activities		
Increase in restricted cash	(69,206)	-
Acquisition of property, plant and equipment	(129,413)	(31,314)
Acquisition of intangible assets	(308,767)	-
Proceeds from disposal of assets (note 5)	-	4,502,578
Balance of sale	500,000	300,000
	<u>(7,386)</u>	<u>4,771,264</u>
Financing activities		
Increase in restricted cash	(145,386)	-
Increase (decrease) of bank loan	(233,563)	203,048
Repayment of long-term debt	(67,177)	(76,471)
Repayment of government royalty program obligation	(118,000)	(300,000)
	<u>(564,126)</u>	<u>(173,423)</u>
Effect of exchange rate changes on cash	(294,149)	(263,337)
Increase (decrease) in cash during the year	(1,826,630)	1,490,937
Cash – Beginning of year	2,835,051	1,344,114
Cash – End of year	<u>1,008,421</u>	<u>2,835,051</u>
Additional information		
Interest paid	129,620	103,069

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(expressed in Canadian dollars)

1 Nature of business and liquidity risk

a) Nature of business

Xebec Adsorption Inc. (“Xebec” or the “Company”) is a global provider which specializes in the design and manufacture of cost-effective and environmentally responsible purification, separation, dehydration and filtration equipment for gases and compressed air. Xebec’s main product lines are: biogas plants for the purification of biogas from agricultural digesters, landfill sites and waste water treatment plants, natural gas dryers for natural gas refuelling stations, associated gas purification systems which enable diesel displacement on drilling sites, and hydrogen purification systems for fuel cell and industrial applications. The Company is incorporated and domiciled in Canada and is listed on the TSX Venture (TSXV) Exchange under the symbol XBC-V. The address of its registered office is 730 Industriel Boulevard, Blainville, Quebec, Canada.

b) Liquidity risk

The Company has realized an operating loss of \$678,754, had cash outflows from operating activities of \$960,969 for the year ended December 31, 2014 and finished the year with cash amounting to \$1,008,421, working capital deficit of \$189,646 and had access to credit facilities totalling \$500,000 of which no amount has been used (see note 11). During the year, management undertook various initiatives and developed a plan to manage its operating and liquidity risks in light of prevailing economic conditions. Management is also currently seeking alternative financings for its operations. The Company has prepared a budget for 2015 for which management believes the assumptions are reasonable. Achieving budgeted results is dependent on improving the volume of revenues in Canada, United States and China, delivering on sales and contracts schedules, meeting expected overall operating margin levels and controlling general and administrative costs. Management expects to meet its budget and to have enough liquidity to fund operations to at least beyond December 31, 2015.

The Company is thus faced with uncertainties that may have an impact on future operating results and liquidity. These uncertainties include fluctuations in foreign currency rates and achieving the Company’s business plan goals as mentioned in the previous paragraph, which includes the development of a new business segment. While management believes it has developed planned courses of action to mitigate operating and liquidity risks, there is no assurance that management will be able to achieve its business plan and maintain the necessary liquidity level including accessing liquidities from China if events or conditions develop that are not consistent with management’s expectations, key budget assumptions for 2015 and planned courses of action. Therefore, the Company may require additional external funding, and there is no assurance that it would be successful. Future changes in capital markets conditions could result in such funding not being available when required or at acceptable costs. The Company is unable to predict the possible effects, if any, of such uncertainties and the potential adjustments to the carrying values of assets and liabilities that could be needed should the Company have insufficient liquidity. Such adjustments could be material.

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(expressed in Canadian dollars)

2 Basis of preparation

The Company prepares its consolidated financial statements in accordance with generally accepted accounting principles in Canada (“GAAP”) as set out in the Chartered Professional Accountants of Canada (“CPA Canada”) Handbook – Accounting which incorporates International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

These consolidated financial statements were approved for issue by the Board of Directors of the Company on April 29, 2015.

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

3 Significant accounting policies

Basis of measurement

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

Basis of consolidation

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

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

Trade receivables

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(expressed in Canadian dollars)

Inventories

Inventories are stated at the lower of cost and net realizable value for raw materials, work in progress and finished goods. Costs of raw materials are determined on an average cost basis. Work in progress and finished goods include materials, direct labour and production overhead (based on normal operating capacity). Net realizable value is the estimated selling price less applicable selling expenses. Inventories are recorded net of any obsolescence provision.

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

Property, plant and equipment

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

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

Machinery and equipment	3 to 10 years
Office furniture and equipment	2 to 5 years
Computers	3 years
Moulds	5 years
Vehicles	5 years

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

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(expressed in Canadian dollars)

Identifiable intangible assets

The Company's intangible assets consist of customer relations and software. It also comprises capitalized development cost when the criteria mentioned in the research and development expenses accounting policy are met. These assets are capitalized and amortized on a straight-line basis in the consolidated statement of earnings (loss) over the period of their expected useful lives.

Customer relations are amortized over six years. Development cost related to a new line or segment are amortized over a period of five years.

Impairment of non-financial assets

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

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

Goodwill

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

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

Trade payables

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(expressed in Canadian dollars)

Provisions

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

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

Financial instruments

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

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

Cash	Loans and receivables
Trade and other receivables	Loans and receivables
Bank loan	Other financial liabilities
Trade and other payables	Other financial liabilities
Accrued liabilities	Other financial liabilities
Long-term debt	Other financial liabilities
Government royalty program obligation	Other financial liabilities

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

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(expressed in Canadian dollars)

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

Impairment of financial assets

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

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

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

Government royalty program obligations

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

Share capital

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(expressed in Canadian dollars)

Revenue recognition

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

Revenues from long-term production-type contracts such as biogas purification equipment and engineering service contracts are determined under the percentage-of-completion method whereby revenues are recognized based on the costs incurred to date in relation to the total expected costs of a contract (costs being composed mainly of materials and labour). Costs and estimated profit on contracts in progress in excess of amounts billed are reflected as work in progress. Cash received in advance of revenues being recognized on contracts is recorded as deferred revenue.

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

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

Government assistance

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

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

Leases

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

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

Xebec Adsorption Inc.

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(expressed in Canadian dollars)

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

Stock-based compensation plans

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

Research and development expenses

Research expenses are charged to expenses as incurred. Development expenses are charged to expenses as incurred unless they meet criteria for deferral and amortization. During the year ended December 31, 2014, development expenses have been deferred and accounted for as identified intangible asset.

Income taxes

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

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

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

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

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

Earnings per share

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

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

Foreign currency translation

a) Functional and presentation currency

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

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

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

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b) Transactions and balances

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

Segment reporting

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

New accounting standards and amendments

The following standards and amendments have been adopted by the Company for the first time for the financial year beginning on January 1, 2014.

Amendment to International Accounting Standard (IAS) 32, Financial Instruments: Presentation, on offsetting financial assets and financial liabilities. This amendment clarifies that the right of set-off must not be contingent on a future event. It must also be legally enforceable for all counterparties in the normal course of business, as well as in the event of default, insolvency or bankruptcy. The amendment also considers settlement mechanisms. The amendment did not have a significant effect on the Company's separate financial statements.

Amendment to IFRS 2, Share-based Payment, to clarify the definition of vesting conditions applicable to share-based payment transactions with a grant date on or after July 1, 2014. The Corporation determined that the adoption of the amended standard had no impact on its consolidated financial statements.

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

The following standards and amendments have been published and their adoption is mandatory for future accounting periods.

In November 2009, the IASB issued IFRS 9 - Financial Instruments. It addresses classification and measurement of financial assets and replaces the multiple category and measurement models in IAS 39 for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments with fair value measurement adjustments for such instruments recognized either through profit or loss or through other comprehensive income. Where such equity instruments are measured at fair value through other comprehensive income, dividends, to the extent that they do not clearly represent a return of investment, are recognized in profit or loss; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely. In addition, the standard includes guidance on financial liabilities and derecognition of financial instruments.

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In July 2014, the IASB issued the final version of IFRS 9 - Financial Instruments. The new standard will replace IAS 39 - Financial Instruments: Recognition and Measurement. The final amendments made in the new version include guidance for the classification and measurement of financial assets and a third measurement category for financial assets, fair value through other comprehensive income. The standard also contains a new expected loss impairment model for debt instruments measured at amortized cost or fair value through other comprehensive income, lease receivables, contract assets and certain written loan commitments and financial guarantee contracts. The standard is effective for annual periods beginning on or after January 1, 2018 and must be applied retrospectively with some exception. Early application is permitted. Restatement of prior periods in relation to the classification and measurement, including impairment, is not required. At this time, the Corporation is still evaluating the impact of these changes but does not anticipate that they will have a significant impact, if any, on its consolidated financial statements.

In November 2013, the IASB issued an amendment to clarify the application of IAS 19- Employee Benefits to plans that require employees or third parties to contribute towards the cost of benefits. The amendment allows contributions that are linked to service, and do not vary with the length of employee service, to be deducted from the cost of benefits earned in the period that the service is provided. The amendment is effective for years beginning on or after July 1, 2014 with early adoption permitted. At this time, the Corporation does not anticipate that this amendment will have an impact on its consolidated financial statements.

In December 2013, the IASB issued Annual Improvements to IFRSs 2010-2012 Cycle and Annual Improvements to IFRSs 2011-2013 Cycle which include the following amendments which are effective for years beginning on or after July 1, 2014:

IFRS 8- Operating Segments: Amended to require disclosure of judgments made by management in aggregating segments and the reconciliation of segment assets to the entity's assets if reported.

IAS 24- Related Party Disclosures: Amended to revise the definition of related party and clarify certain disclosures.

IFRS 3- Business Combinations: Amended to clarify the scope exemption for joint arrangements. At this time, the Corporation does not anticipate that these changes will have a significant impact, if any, on its consolidated financial statements.

In May 2014, the IASB issued IFRS 15 - Revenue from Contracts with Customers. IFRS 15 replaces all previous revenue recognition standards, including IAS 18 - Revenue, and related interpretations such as IFRIC 13 - Customer Loyalty Programmes. The standard sets out the requirements for recognizing revenue. Specifically, the new standard introduces a comprehensive framework with the general principle being that an entity recognizes revenue to depict the transfer of promised goods and services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard introduces more prescriptive guidance than was included in previous standards and may result in changes in classification and disclosure in addition to changes in the timing of recognition for certain types of revenues. The new standard is effective for annual periods beginning on or after January 1, 2017 with early adoption permitted. At this time, management is reviewing the impact that this standard will have on its consolidated financial statements.

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In September 2014, the IASB issued Annual Improvements to IFRSs 2012-2014 Cycle. The following is a summary of the relevant and key clarifications and amendments:

IFRS 5 - Non-Current Assets Held for Sale and Discontinued Operations was amended to clarify that a change in disposal method should not be considered to be a new plan of disposal but a continuation of the original plan. There is therefore no interruption of the application of the requirements in this standard. The amendment also clarifies that changing the disposal method does not change the date of classification.

IAS 19 - Employee Benefits was amended to clarify that market depth of high quality corporate bonds is assessed based on the currency in which the obligation is denominated rather than where the obligation is located. When there is no deep market for high quality corporate bonds in that currency, government bond rates must be used. These amendments must be applied in annual periods beginning on or after January 1, 2016, with earlier application permitted. This publication also includes the following amendments which are to be applied retrospectively for annual periods beginning on or after January 1, 2016 with early application permitted:

IFRS 7 - Financial Instrument: Disclosures was amended to clarify that offsetting disclosures are not required in the condensed interim financial statements.

IAS 34 - Interim Financial Reporting was amended to clarify the meaning of 'elsewhere in the interim financial report' and states that the required interim disclosures must be either in the interim financial statements or incorporated by cross-reference between the interim financial statements and wherever they are included within the greater interim financial report. At this time, the Corporation does not anticipate that these changes will have a significant impact, if any, on its consolidated financial statements.

In September 2014, the IASB issued amendments to IFRS 10 - Consolidated Financial Statements and IAS 28 - Investments in Associates and Joint Ventures to address inconsistencies between the standards. Specifically, the amendment clarifies that a full gain or loss is recognized when the transaction involves a business combination and a partial gain is recognized when the transaction involves assets that do not constitute a business. The amendment is effective for annual periods beginning on or after January 1, 2016 with early adoption permitted.

In December 2014, the IASB issued amendments to clarify IAS 1- Presentation of Financial Statements and guidance on materiality and aggregation, the presentation of subtotals, the structure of financial statements and the disclosure of accounting policies. The amendment is effective for annual periods beginning on or after January 1, 2016. At this time, the Corporation does not anticipate that these changes will have a significant impact on its consolidated financial statements.

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4 Significant accounting judgments and estimation uncertainties

Critical accounting estimates and judgments

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

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

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

- ii. Impairment of customer relations

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

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

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

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5 Gain on disposal of assets

In 2012, the Company sold to Air Products and Chemicals Inc. (Air Products) its intellectual property portfolio, including the patents and patent applications relating to its gas separation technology. In that transaction, the Company had also transferred ownership of its research and development facilities in Burnaby and Surrey, as well as other equipment located in British Columbia. The Company had received aggregate gross proceeds of \$9,600,000 and net proceeds of approximately \$9,415,000. The agreement also foresaw future proceeds related to the achievement of certain conditions to be met by Xebec within the next few months. With the net proceeds received, the Company reimbursed its bank loan of \$500,000 and its subordinated loan of \$83,700.

In 2013, the Company received additional gross proceeds of \$6,237,000 and net proceeds of approximately \$4,500,000 in relation to the achievement of certain conditions. As at December 21, 2013, the transaction was completed, and no additional proceeds can be generated.

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

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

The following table summarizes the gain on disposal of assets:

	2014 \$	2013 \$
Additional proceeds	-	6,236,437
Transaction fees	-	(1,738,827)
Net proceeds	-	4,497,610
Gain on disposal of assets	-	4,497,610

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6 Restricted cash

Restricted cash consist in a guarantee investment certificate equivalent to \$152,827 and pledge against a loan to the China subsidiary and cash equivalent to \$69,103 retained by the liquidator of the South East Asia subsidiary.

7 Trade and other receivables

	2014 \$	2013 \$
Trade receivables	2,438,197	2,576,933
Other receivables	460,135	772,187
Less: Allowance for doubtful accounts	(217,021)	(433,420)
Trade and other receivables – net	<u>2,681,311</u>	<u>2,915,700</u>

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

8 Inventories

	2014 \$	2013 \$
Raw materials	1,045,569	851,722
Work in progress	623,781	570,495
Finished goods	-	116,963
Inventories	<u>1,669,350</u>	<u>1,539,180</u>

Cost of goods sold includes cost of inventories amounting to \$6,240,259 in 2014 (2013 - \$5,274,607) including amounts of nil (2013 – \$492,726) for the writedown of inventories to the lower of cost and net realizable value.

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

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9 Property, plant and equipment

	Machinery and equipment	Office furniture and equipment	Computers	Moulds	Vehicles	Leasehold improvement	Total
	\$	\$	\$	\$	\$	\$	\$
Cost							
Balance at December 31, 2012	446,738	98,960	226,716	82,367	35,984	9,542	900,307
Additions	25,323	-	5,991	-	-	-	31,314
Disposal	(4,273)	(14,679)	(32,497)	-	-	(9,458)	(60,907)
Effect of movements in exchange rates	9,983	6,871	10,218	8,251	-	(84)	35,239
Balance at December 31, 2013	477,771	91,152	210,428	90,618	35,984	-	905,953
Additions	-	47,398	14,979	67,036	-	-	129,413
Effect of movements in exchange rates	6,983	5,122	7,235	5,777	-	-	25,117
Balance at December 31, 2014	484,754	143,672	232,642	163,431	35,984	-	1,060,483
Accumulated depreciation							
Balance at December 31, 2012	186,049	79,436	185,335	51,977	17,992	9,542	530,331
Depreciation	43,612	11,748	16,485	14,397	7,197	-	93,439
Disposal	(3,193)	(11,743)	(31,545)	-	-	(9,458)	(55,939)
Effect of movements in exchange rates	6,272	6,227	9,150	5,981	-	(84)	27,546
Balance at December 31, 2013	232,740	85,668	179,425	72,355	25,189	-	595,377
Depreciation	44,805	11,534	20,230	12,466	7,196	-	96,231
Effect of movements in exchange rates	4,972	4,680	6,475	4,903	-	-	21,030
Balance at December 31, 2014	282,517	101,882	206,130	89,724	32,385	-	712,638
Carrying Amount							
At December 31, 2013	245,031	5,484	31,003	18,263	10,795	-	310,576
At December 31, 2014	202,237	41,790	26,512	73,707	3,599	-	347,845

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10 Intangible assets and goodwill

	Customer relations	Other Software	Internally generated Development costs	Total intangible assets	Goodwill
	\$	\$	\$	\$	\$
Cost					
Balance at December 31, 2012	1,900,000	245,573	-	2,145,573	142,616
Additions	-	-	-	-	-
Effect of movements in exchange rates	-	8,746	-	8,746	-
Balance at December 31, 2013	1,900,000	254,319	-	2,154,319	142,616
Additions	-	10,281	298,485	308,766	-
Effect of movements in exchange rates	-	6,294	-	6,294	-
Balance at December 31, 2014	1,900,000	270,894	298,485	2,469,379	142,616
Accumulated amortization					
Balance at December 31, 2012	950,000	217,315	-	1,167,315	-
Amortization for the year	158,333	10,934	-	169,267	-
Effect of movements in exchange rates	-	8,224	-	8,224	-
Balance at December 31, 2013	1,108,333	236,473	-	1,344,806	-
Amortization for the year	158,333	11,922	29,040	199,295	-
Effect of movements in exchange rates	-	5,981	-	5,981	-
Balance at December 31, 2014	1,266,666	254,376	29,040	1,550,082	-
Carrying amount					
At December 31, 2013	791,667	17,846	-	809,513	142,616
At December 31, 2014	633,334	16,518	269,445	919,297	142,616

Amortization of \$199,295 (2013 – \$169,267) is included in the consolidated statement of earnings (loss): \$3,458 (2013 – \$4,241) in cost of goods sold; and \$195,827 (2013 – \$165,026) in selling and administrative expenses.

As at December 31, 2013, management determined that an indicator of impairment existed for the customer relations while comparing its financial forecasts to prior period forecasts and considering other market factors and indicators. The recoverable amount of the customer relations has been determined based on a value-in-use calculation using cash flow projections from financial budgets approved by senior management covering a six-year period. The pre-tax discount rate applied to cash flow projections is 15%. As a result of this analysis, management determined that no impairment charge was required.

For the realization of its impairment test on goodwill, the Company allocates its entire goodwill to one CGU, the Company as a whole, because it is the lowest level at which the goodwill is monitored for internal purposes.

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To perform the test, the management has used the approach of fair value less costs to sell. The fair value is derived from the market capitalization of the Company for the year ended December 31, 2014. Management determined that the fair value less costs to sell was higher than the carrying value of the CGU. As a result of this analysis, management determined that no impairment charge was required.

11 Bank loan

As at December 31, 2014, the Company has a revolving demand facility by way of letters of credit and letters of guarantee amounting to \$1,000,000 with Royal Bank of Canada which bear interest at the Royal Bank's prime rate plus 2.5% per annum and which are limited by certain margin requirements concerning trade and other receivables. As at December 31, 2014, an amount of \$174,015 (2013 – \$85,000) was drawn on this credit facility.

In addition, the Company has access to credit facilities in the amount of \$500,000 with Royal Bank of Canada which are guaranteed by Export Development Canada, and bear interest at the Royal Bank's prime rate plus 2.5% per annum and are limited by certain requirements concerning pre-shipment costs. These credit facilities were not used as at December 31, 2014 (2013 – \$370,000).

The credit facilities are secured by a first ranking hypothec of \$4,000,000 on all movable property of the Company and are renewable annually.

12 Trade and other payables

	2014	2013
	\$	\$
Trade payables	3,421,700	3,040,365
Payables to related parties (note 26)	7,885	38,265
Other payables	62,312	350,790
Trade and other payables	<u>3,491,897</u>	<u>3,429,420</u>

13 Deferred revenue

	2014	2013
	\$	\$
Deferred revenue from long-term contracts	46,358	676,320
Deferred revenue other contracts	768,652	666,474
Deferred revenue	<u>815,010</u>	<u>1,342,794</u>

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Revenue recognized for long-term contracts amounted to \$1,945,581 for the year ended December 31, 2014 (2013 – \$3,316,058). Costs incurred for long-term contracts in progress as at December 31, 2014 amounted to \$205,874, for a profit of \$141,293 (2013 – costs of \$504,314, for a loss of \$456,897).

14 Provisions

	Provision for contingencies	Anticipated loss on long-term contract	Warranty costs	Total provision
	(a)	(b)	(c)	
	\$	\$	\$	\$
At December 31, 2012	-	-	488,000	488,000
Additional provisions	-	297,269	199,288	496,557
Unused amount reversed	-	-	(51,926)	(51,926)
Used during year	-	-	(130,559)	(130,559)
At December 31, 2013	-	297,269	504,803	802,072
Additional provisions	207,691	-	139,493	347,184
Unused amount reversed	-	(297,269)	(386,890)	(684,159)
Used during the year	-	-	(35,742)	(35,742)
At December 31, 2014	207,691	-	221,664	429,355
Current portion of provisions	207,691	-	28,674	236,365
Non-current provisions	-	-	192,990	192,990

(a) Provision for contingencies

The Company has estimated potential loss and consequently, recognized the expected expense.

(b) Anticipated loss on long term contract

The Company entered in an amended agreement for the biogas contract project for which a provision was created last year. As a result of the amended agreement, the provision was no more required and has been reversed.

(c) Warranty cost

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

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15 Long-term debt

a) Loans

	2014 \$	2013 \$
Loan from Canada Economic Development for a maximum of \$33,346 (2013 – \$66,670), matures December 2015, bears no interest and is repayable in monthly instalments of \$2,777	33,346	66,670
Loan from Canada Economic Development for a maximum of \$12,500 (2013 – \$37,500), matures January 2015 and bears no interest	12,500	37,500
Term finance contract, matures June 2015, bears annual interest of 5.99%is secured by a lien on a vehicle (net book value of \$3,599)and is repayable in monthly instalments of \$785 including capital and interest	4,629	13,482
	<u>50,475</u>	<u>117,652</u>
Less: Current portion	50,475	67,176
	<u>-</u>	<u>50,476</u>

b) Disposal of building and land

On September 30, 2011, the Company sold and leased back its building. The balance of sale of \$500,000 has been paid to the Company in 2014.

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c) Government royalty program obligations

In 2012, the Company signed a settlement agreement with Technology Partnership Canada (TPC) with regard to the Company's Fast Cycle Pressure Swing Adsorption and Gas Management systems and Pulsar Pressure Swing Adsorption project. The Company had to pay \$250,000 at the execution of the agreement and \$1,000,000 spread over four equal annual non-interest bearing payments, starting on January 31, 2013. Furthermore, the Company was liable to pay up to \$750,000 in contingent payments based on proceeds from the sale by the Company of its intellectual property. Upon closing of the transaction (see note 5), the Company paid \$540,000 out of the \$750,000 total contingent-based payments. On October 23, 2012, the Company accrued another \$150,000 out of the \$750,000 total contingent based payments, following additional proceeds received (see note 5), leaving a potential maximum amount to be paid of \$60,000 as at December 31, 2012.

In 2013, the Company realized the last milestone pursuant to the transaction and paid the remaining \$60,000. The Company renegotiated its payments terms with TPC, changing from an annual payment of \$250,000 to monthly payments of \$24,500 but adding an extra year to term.

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

	2014	2013
	\$	\$
Balance – Beginning of year	846,461	1,080,812
Accretion interest	34,364	34,041
Additional contingent debt	-	60,000
Loss (gain) on debt settlement	-	(28,392)
Repayment	(118,000)	(300,000)
Balance – End of year	762,825	846,461
Current portion	762,825	259,636
	-	586,825

In 2013, the amendment to the settlement agreement with TPC was accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability, as the terms and conditions are substantially different. The Company recorded a gain on debt settlement of \$28,392 in the consolidated statement of earnings (loss) (see note 20).

The carrying amount of the government royalty program obligation has been calculated by discounting the future cash flows at a 5% interest rate.

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16 Share capital

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

Information that summarizes the activity related to the Company's share purchase warrants for the year ended December 31, 2014:

	2014		2013	
	Number of warrants	Weighted average exercise price \$	Number of warrants	Weighted average exercise price \$
Balance – Beginning of year	10,091,886	0.45	10,091,886	0.45
Granted	-	-	-	-
Exercised	-	-	-	-
Expired	-	-	-	-
Balance – End of year	10,091,886	0.45	10,091,886	0.45

The following table summarizes the share purchase warrants outstanding as at December 31, 2014, all of which are exercisable:

	Warrants outstanding		
Exercise price \$	Number of warrants outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price \$
0.45	10,091,886	0.84	0.45
	10,091,886	0.84	0.45

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c) Earnings (loss) per share

i. Basic

Basic earnings (loss) per share is calculated by dividing net earnings (loss) attributable to shareholders of the Company by the weighted average number of common shares in issue during the year.

	2014	2013
	\$	\$
Net earnings (loss) attributable to shareholders of the Company	(782,614)	396,892
Weighted average number of common shares in issue	39,363,867	39,363,867
Basic earnings (loss) per share	<u>(\$0.02)</u>	<u>\$0.01</u>

ii. Diluted

Diluted earnings per share is calculated by adjusting the weighted average number of common shares outstanding to assume conversion of all dilutive potential common shares. The Company has two categories of dilutive potential common shares: warrants and stock options. For both, a calculation is performed to determine the number of shares that could have been acquired at fair value (determined as the average market share price of the Company's outstanding shares for the period), based on the monetary value of the subscription rights attached to the warrants and stock options. The number of shares calculated below is compared with the number of shares that would have been issued assuming exercise of the warrants and stock options. All such instruments were antidilutive for the year ended December 31, 2014.

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	2014 \$	2013 \$
Net earnings (loss) attributable to the shareholders of the Company	(782,614)	396,892
Weighted average number of common shares in issue	39,363,867	39,363,867
Dilutive effect of stock options	-	2,400,000
Diluted weighted average number of shares	39,363,867	41,763,867
Diluted earnings (loss) per share	(\$0.02)	\$0.01
Items excluded from the calculation of diluted net earnings (loss) per share because the exercise price was greater than the average market price of the common shares or due to their anti-dilutive effect		
Stock options	4,438,401	1,916,804
Warrants (number of equivalent shares)	10,091,886	10,091,886

17 Stock options

The stock option plan (the 2010 Plan) allowed for the issuance of stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards and other stock-based awards. Under the 2010 Plan, common shares approved for issuance under all stock-based compensation arrangements were limited to the greater of 591,560 or 10% of the common shares issued and outstanding.

The Compensation Committee recommended to the directors, who approved, on May 9, 2013, that the 2010 Plan be renewed and that it be amended and restated in order to (i) change the name of the plan to Xebec Adsorption 2013 Amended and Restated Omnibus Plan (the 2013 Plan) and (ii) change the relevant provisions therein so that the aggregate number of common shares which could be granted pursuant to the 2013 Plan not exceed 15% of all issued and outstanding common shares of the Company from time to time (versus 10% in the 2010 Plan). The 2013 Plan was approved by the shareholders on June 13, 2013. On December 23, 2013, the Board of Directors approved amendments to the 2013 Plan that were required to comply with TSXV requirements. In accordance with the provisions of the 2013 Plan, the amendments did not require shareholder approval but required approval by the TSXV. The amendments include renaming the 2013 Plan the Xebec Adsorption Stock Option Plan and moving from a rolling 15% of stock options available for issuance to a fixed number of 5,904,580 common shares available for grant. As at December 31, 2014, the maximum number of common shares available for issuance under all stock-based compensation arrangements is 5,904,580.

Under the terms of the Xebec Adsorption Stock Option Plan, stock options are granted with an exercise price not less than the volume-weighted average trading price of the common shares for the five trading days prior to the date of grant. The terms and conditions for acquiring and exercising options are set by the Board of Directors. Stock options for employees vest no less than at grant date and no more than quarterly. The vesting right acquisitions are either gradual and equal over four years or at the grant date

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and are exercisable for three to seven years from the date of grant. Stock options for directors vest at the grant date and are exercisable for seven years from the grant date.

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

	2014		2013	
	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
Outstanding – Beginning of year	4,316,804	0.18	3,430,457	0.19
Granted	2,500,000	0.12	1,032,260	0.16
Cancelled	(978,402)	0.17	(145,913)	0.31
Expired	-	-	-	-
Outstanding – End of year	5,838,402	0.16	4,316,804	0.18
Exercisable – End of year	4,438,401	0.16	4,316,804	0.18

As at December 31, 2014, options outstanding and exercisable are as follows:

2014					
Exercise price range \$	Options outstanding			Options exercisable	
	Number of options	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
0.10 – 0.20	5,296,130	5.27	0.12	3,896,129	0.12
0.22 – 0.27	527,272	3.57	0.24	527,272	0.24
12.00 – 12.25	15,000	1.71	12.00	15,000	12.00
	5,838,402	5.11	0.16	4,438,401	0.17

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

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	2014		2013	
	Non-employees	Employees	Non-employees	Employees
Dividend yield	0%	0%	0%	-
Exercise price	\$0.14	\$0.12	\$0.16	-
Risk-free interest rate	1.06%	1.15%	1.15%	-
Estimated life	2 years	2 years	2 years	-
Expected volatility	81%	81%	81%	-
Stock price	\$0.12	\$0.14	\$0.16	-

The weighted average fair value of the options granted to employees in 2014 was \$0.05 and there were no options granted to employees in 2013.

The weighted average fair value of the options granted to non-employees during the year is \$0.06 per common share (2013- \$0.07).

Compensation expense with respect to these options amounted to \$47,488 for employees and \$24,595 for non-employees for the year ended December 31, 2014 (2013 – \$6,757 and \$64,726).

18 Expenses by nature

	2014	2013
	\$	\$
Material	6,240,259	5,274,607
Employee salaries and benefits	5,792,079	5,963,254
Travel expenses	870,152	704,712
Professional fees	654,405	684,092
Rent and repairs and maintenance	607,827	682,858
Office expense	458,431	399,973
Depreciation and amortization	295,526	262,705
Subcontracting costs	277,434	841,075
Stock-based compensation	72,083	71,483
Commission	47,052	36,032
Other	(275,822)	634,777
	<u>15,039,426</u>	<u>15,555,568</u>

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19 Research and development expenses

	2014	2013
	\$	\$
Material	154,313	19,259
Professional fees	24,390	65,803
Employee salaries and benefits	23,095	207,035
Travel expenses	406	1,966
Rent and repairs and maintenance	-	1,975
Government grants	(5,000)	(5,000)
Research and development tax credits	27,337	(273,635)
	<u>224,541</u>	<u>17,403</u>

20 Finance expenses

	2014	2013
	\$	\$
Interest and bank charges	39,910	31,023
Interest on bank loan	-	23,316
Interest on long-term debt	569	1,081
Interest charges	89,142	47,648
Accretion and revaluation of government royalty program obligation (see note 15 (c))	34,364	94,041
	<u>163,985</u>	<u>197,109</u>

21 Compensation of key management

Compensation awarded to key management included:

	2014	2013
	\$	\$
Salaries and short-term employee benefits	980,551	690,389
Stock-based compensation	72,083	64,919
Termination benefits	93,727	-
	<u>1,146,361</u>	<u>755,308</u>

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

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22 Income taxes

a) Income tax expense

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

	2014	2013
	\$	\$
Current	-	-
Deferred	-	-
	<hr/>	<hr/>
	-	-
	<hr/>	<hr/>

b) Effective tax rate

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

	2014	2013
	%	%
Combined statutory rate applied to pre-tax earnings (loss)	26.90	26.89
Non-deductible items	(0.85)	1.14
Non-taxable portion of tax credits	(6.77)	-
Net change in unrecognized deferred income tax assets	37.55	12.88
Impact of expiration of non-capital losses available to carryforward	(91.42)	-
Impact of changes in income tax rates on deferred income taxes	41.73	(10.94)
Other	(7.14)	0.35
Non-taxable portion of gain on disposal of assets	-	(30.32)
	<hr/>	<hr/>
Effective income tax rate	-	-

The applicable statutory tax rate is 26.9% in 2014 and 26.89% in 2013. The Company's applicable tax rate is the Canadian federal and provincial combined rate applicable in the jurisdictions in which the Company operates.

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c) Deferred income tax assets and liabilities

	2014 \$	2013 \$
Deferred income tax assets		
Property, plant and equipment	213,891	-
Net operating losses carried forward	14,710,183	15,777,888
Financing costs	-	38,712
Scientific research and development expenses	6,479,129	6,517,195
Investment tax credits	3,922,377	3,975,586
Other	122,150	171,905
	<u>25,447,730</u>	<u>26,481,286</u>
Deferred income tax liabilities		
Intangible assets	(244,798)	(216,514)
Property, plant and equipment	-	(5,376)
	<u>25,202,932</u>	<u>26,259,396</u>
Unrecognized deferred income tax assets	<u>(25,202,932)</u>	<u>(26,259,396)</u>
Net deferred income tax assets (liabilities)	<u>-</u>	<u>-</u>

In assessing the realizability of deferred income tax assets, management considers whether it is probable that some portion or all of the deferred income tax assets will be realized. The ultimate realization of deferred income tax assets is dependent on the generation of future taxable income during the periods in which those temporary differences become deductible. As management believes there is sufficient uncertainty regarding the realization of deferred income tax assets, these deferred income tax assets have not been recognized.

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

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d) Other

The Company has non-capital losses carried forward in Canada of approximately \$54,800,000 (2013 –\$55,060,000) which are available to reduce taxable income in future years, the benefit of which has not been recorded in the accounts, and which expire as follows:

	\$
2025	6,900,000
2026	7,200,000
2027	6,800,000
2028	10,800,000
2029	7,200,000
2030	12,400,000
2031	500,000
2032	500,000
2033	<u>2,500,000</u>
	<u>54,800,000</u>

The Company has scientific research and experimental development expenses of approximately \$24,110,000 (2013 – \$24,300,000) which are available to be carried forward indefinitely and deducted against future taxable income otherwise calculated. The potential benefit has not been recorded in the accounts.

As at December 31, 2014, the Company also has investment tax credits of approximately \$5,366,000 (2013 – \$5,407,000) available to offset future Canadian federal income taxes payable. The potential benefit of the investment tax credits has not been recognized in the accounts and expires as follows:

	\$
2016	10,000
2017	30,000
2018	100,000
2019	470,000
2020	910,000
2021	240,000
2022	920,000
2023	480,000
2024	740,000
2025	650,000
2026	410,000
2027	240,000
2029	-
2031	32,000
2032	97,000
2033	<u>37,000</u>
	<u>5,366,000</u>

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23 Supplemental Cash flow information

Net change in non-cash working capital balances related to operations consists of the following:

	2014	2013
	\$	\$
Decrease (increase) in assets:		
Trade and other receivables	234,389	1,021,046
Inventories	(130,361)	(351,430)
Investment tax credits receivable	87,760	(62,760)
Other current assets	162,760	(133,899)
Increase (decrease) in liabilities:		
Trade and other payables	249,958	(252,452)
Accrued liabilities	(81,673)	(338,976)
Deferred revenues	(527,784)	274,807
Other operating liabilities	(372,717)	314,072
	<u>(377,668)</u>	<u>470,408</u>

24 Commitments

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

As at December 31, 2014	Payment Due by Period			
	1 year	2 - 5 years	Beyond 5 years	Total
	\$	\$	\$	\$
Operating leases	462,796	1,269,464	2,236,672	3,968,931
	<hr/>			
As at December 31, 2013	Payment Due by Period			
	1 year	2 - 5 years	Beyond 5 years	Total
	\$	\$	\$	\$
Operating leases	732,077	1,319,923	2,543,033	4,595,033

Operating leases include one building in Blainville, Quebec, and various equipment leases.

25 Contingent liabilities

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

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26 Related party transactions

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

	2014	2013
	\$	\$
Marketing and professional service expenses paid to companies controlled by members of the immediate family of an officer	108,165	132,077
Sales to an entity controlled by a subsidiary manager	3,260,776	484,077
Management fees paid to an entity controlled by a subsidiary manager	-	33,869
Cash advances to an entity controlled by a subsidiary manager	-	207,076

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

27 Capital management

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

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

	2014	2013
	\$	\$
Cash	(1,008,421)	(2,835,051)
Bank loan	136,437	370,000
Long-term debt	50,475	117,652
Government royalty program obligation (note 15 (c))	762,825	846,461
	(58,684)	(1,500,938)
Equity	929,291	1,958,988
	<u>870,607</u>	<u>458,050</u>

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

28 Segmented information

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

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

	2014	2013
	\$	\$
Revenue		
United States	4,509,675	3,131,562
Singapore	3,260,776	473,486
Republic of China	2,809,819	1,060,381
Canada	2,137,609	2,139,234
Other	1,650,530	4,506,780
	<u>14,368,409</u>	<u>11,311,443</u>

Revenue summarized by product line is as follows:

	2014	2013
	\$	\$
Product line		
Natural gas dryers	6,652,931	4,458,228
Compressed gas filtration	3,853,568	3,954,704
Biogas purification	2,494,462	2,670,663
Associated gas	974,367	227,848
Engineering services	264,223	-
Air dryers	128,858	-
	<u>14,368,409</u>	<u>11,311,443</u>

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Major customer representing 10% or more of total sales is:

	2014 \$	2013 \$
Customer A	3,256,051	455,120

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

	2014 \$	2013 \$
Non-current assets		
Canada	1,337,833	1,389,781
Asia	66,826	72,924
United States	5,099	-
	<u>1,409,758</u>	<u>1,462,705</u>

29 Financial instruments

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

The following tables show the carrying values and fair values of assets and liabilities by category as at December 31:

December 31, 2014

	<u>Loans and receivables</u>		<u>Other financial liabilities</u>	
	Carrying amount \$	Fair value \$	Carrying amount \$	Fair value \$
Cash	1,008,421	1,008,421	-	-
Trade and other receivables	2,681,311	2,681,311	-	-
Bank loan	-	-	136,437	136,437
Trade and other payables	-	-	3,491,897	3,491,897
Accrued liabilities	-	-	723,890	723,890
Long-term debt	-	-	50,475	49,581
Government royalty program obligation	-	-	762,825	762,825

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December 31, 2013	Loans and receivables		Other financial liabilities	
	Carrying amount	Fair value	Carrying amount	Fair value
	\$	\$	\$	\$
Cash	2,835,051	2,835,051	-	-
Trade and other receivables	2,915,700	2,915,700	-	-
Bank loan	-	-	370,000	370,000
Trade and other payables	-	-	3,429,420	3,429,420
Accrued liabilities	-	-	805,563	805,563
Long-term debt	-	-	117,652	112,018
Government royalty program obligation	-	-	846,461	846,461

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

- Long-term debt: The Company's long-term debt carries fixed interest rates. The fair value of the Company's debt obligations has been calculated by discounting the future cash flows of the long-term debt at the interest rate of similar debt instruments.
- Government royalty program obligation: Fair value of the government royalty program obligation has been calculated by discounting the future cash flows at the interest rate for a similar loan in the market.
- The Company's financial instruments that are measured subsequent to initial recognition at fair value are grouped into Levels 1 to 3 based on the degree to which the fair value is observable:

Level 1 — Fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 — Fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3 — Fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The long-term debt and government royalty program obligation are considered Level 2, and there is no Level 1 or 3.

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(b) Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party fails to meet its contractual obligations. The Company's primary credit risk is its cash and outstanding trade and other receivables. The carrying amount of its outstanding trade and other receivables represents the Company's estimate of its maximum credit exposure. The Company regularly monitors its credit risk exposure and takes steps such as employing credit-approval procedures, establishing credit limits, using credit assessments and monitoring practices to mitigate the likelihood of these exposures from resulting in an actual loss. An allowance for doubtful accounts amounting to \$217,021 (2013 – \$433,420) was established based on prior experience and an assessment of current financial conditions of customers as well as the general economic environment. In cases where an allowance for doubtful accounts provision is recorded and a receivable balance is considered uncollectible, it is written off against the allowance for doubtful accounts. Bad debt reversal amounted to \$228,139 in 2014 (2013 – expense amounted to \$266,236). As at December 31, 2014, the Company's three largest trade debtors accounted for 24% (12%, 6% and 6%) of the total trade and other receivables balance (2013 – 26% (15%, 6% and 5%)).

Details of trade and other receivables were as follows:

	2014	2013
	\$	\$
Current trade receivables	741,720	619,120
Trade receivables past due by:		
1–30 days	416,515	823,032
31–60 days	326,061	246,388
61–90 days	179,215	174,244
Over 90 days	774,686	714,148
	<hr/>	<hr/>
Total trade receivables	2,438,197	2,576,932
Allowance for doubtful accounts	(217,021)	(433,420)
Unbilled and other receivables	460,135	772,188
	<hr/>	<hr/>
Total trade and other receivable	2,681,311	2,915,700

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

	\$
At December 31, 2013	(433,420)
Provision for impairment	(217,021)
Impaired receivables written off during the year as uncollectible – current year	-
Impaired receivables written off during the year as uncollectible – last year	6,151
Receivable collected previously written off	
Unused amounts reversed	<u>427,269</u>
At December 31, 2014	<u>(217,021)</u>

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

(c) Market risk

(i) Currency risk

Certain financial assets and financial liabilities are exposed to foreign exchange fluctuations. Taking into account the amounts denominated in the currencies indicated below and assuming that all of the other variables remain unchanged, a fluctuation in exchange rates would have an impact on the Company's net earnings (loss). Management believes that a 10% change in exchange rates would be reasonably possible and that the impact on net earnings (loss) of such a change would be approximately \$24,671 for 2014 (2013 – \$139,771). As at December 31, 2014, the following accounts are shown in their original currencies and converted into Canadian dollars. The Company does not use financial instruments to reduce this risk.

	<u>2014</u>		
	Renminbi	US dollar	Euro
Cash	-	93,554	9,458
Restricted cash	817,695	-	-
Trade and other receivables	-	410,875	-
Trade and other payables	-	(329,919)	(86,592)
	<u>817,695</u>	<u>174,510</u>	<u>(77,134)</u>
Equivalent in Canadian dollars	<u>152,827</u>	<u>202,449</u>	<u>(108,562)</u>

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	2013		
	Thai baht	US dollar	Euro
Cash	-	635,197	3,439
Trade and other receivables	772,327	1,297,933	-
Trade and other payables and accrued liabilities	-	(476,092)	(124,290)
	<u>772,327</u>	<u>1,457,038</u>	<u>(120,851)</u>
Equivalent in Canadian dollars	<u>25,108</u>	<u>1,549,705</u>	<u>(177,107)</u>

(ii) Interest rate risk

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

The Company is exposed to interest rate risk on its bank loan and long-term debt, for which the interest rates charged fluctuate based on the bank's prime rate. As at December 31, 2014, the short-term bank loan amounted to \$136,437 (2013 – \$370,000). If the interest rate on the bank debt had been 50 basis points higher (lower), related to the bank loan as at December 31, 2014, net earnings (loss) would have been \$1,103 (2013 – \$2,076) lower (higher).

(d) Liquidity risk

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

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

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30 Subsequent events

In 2015, the Company renegotiated its payments terms with TPC moving from a monthly payment of \$24,500 to a monthly payment of:

- \$5,000 starting from April 30, 2015 to September 30, 2015
- \$10,000 starting from October 31, 2015 to March 31, 2016
- \$24,500 starting from April 30, 2016 to December 31, 2016
- And the balance of \$504,500 on January 31, 2017.