

Xebec Adsorption Inc.

Consolidated Financial Statements
December 31, 2016 and 2015
(expressed in Canadian dollars)



Raymond Chabot Grant Thornton

Independent Auditor's Report

To the Shareholders of
Xebec Adsorption Inc.

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We have audited the accompanying consolidated financial statements of Xebec Adsorption Inc. which comprise the consolidated statements of financial position as at December 31, 2016 and the consolidated statement of loss, the consolidated statement of comprehensive loss, changes in equity and cash flows for the year then ended, and 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 (IFRS) 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 audit. We conducted our audit 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.

We believe that the audit evidence we have obtained 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. as at December 31, 2016 and its financial performance and its cash flows for the year then ended, in accordance with International Financial Reporting Standards (IFRS).

Emphasis of matter

Without modifying our opinion, we draw attention to Note 1 to the consolidated financial statements which indicates the existence of a material uncertainty that may cast significant doubt of the Company's ability to continue as a going concern.

Other matter

The consolidated financial statements of Xebec Adsorption Inc. for the year ended December 31, 2015, were audited by another auditor who expressed an unmodified opinion on those financial statements on April 28, 2016.

Raymond Chabot Grant Thornton LLP¹

Montreal

April 24, 2017

¹ CPA auditor, CA public accountancy permit no. A125741

Xebec Adsorption Inc.

Consolidated Statements of Financial Position

As at December 31, 2016 and 2015

(expressed in Canadian dollars)

	2016 \$	2015 \$
Assets		
Current assets		
Cash	1,088,592	2,717,965
Trade and other receivables (note 5)	2,449,441	2,437,159
Inventories (note 6)	1,329,516	1,141,840
Investment tax credits receivable	47,953	117,676
Other current assets	188,297	158,856
Total current assets	5,103,799	6,573,496
Non-current assets		
Property, plant and equipment (note 7)	274,538	322,395
Intangible assets (note 8)	190,743	240,783
Total non-current assets	465,281	563,178
Total assets	5,569,080	7,136,674
Liabilities		
Current liabilities		
Bank loan (note 9)	755,000	375,000
Trade, other payables and accrued liabilities (note 10)	3,623,259	3,898,728
Deferred revenue (note 11)	942,575	680,003
Current portion of long-term debt (note 12 a))	22,112	-
Current portion of government royalty program obligation (notes 12b))	757,540	243,207
Current portion of provisions (note 13)	209,133	698,561
Total current liabilities	6,309,619	5,895,499
Non-current liabilities		
Government royalty program obligation (note 12b))	-	480,834
Long-term debt (note 12 a))	774,788	-
Obligation arising from shares issued by a subsidiary (note 14)	3,582,135	3,583,808
Government grants	2,083	7,083
Deferred rent	138,516	112,132
Provisions (note 13)	8,926	20,013
Total non-current liabilities	4,506,448	4,203,870
Total liabilities	10,816,067	10,099,369
Equity		
Equity attributable to shareholders of the Company		
Share capital (note 15)	19,318,856	19,318,856
Contributed surplus	2,996,621	2,925,379
Equity component of convertible debentures (note 12 a))	150,304	-
Accumulated other comprehensive loss	(940,216)	(1,105,821)
Deficit	(26,772,552)	(24,101,109)
Total equity	(5,246,987)	(2,962,695)
Total liabilities and equity	5,569,080	7,136,674

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 Loss

For the years ended December 31, 2016 and 2015

(expressed in Canadian dollars)

	2016	2015
	\$	\$
Revenue (note 27)	9,587,381	11,350,626
Cost of goods sold	7,419,727	8,545,625
Gross margin	2,167,654	2,805,001
Research and development expenses (note 18)	142,696	365,365
Selling and administrative expenses	4,354,639	5,222,610
Foreign exchange loss (gain)	213,303	(549,039)
(Gain)/loss on conversion of shares issued by a subsidiary (note 14)	(352,248)	67,867
Impairment charge of intangible assets and goodwill (note 8)	-	696,783
	4,358,390	5,803,586
Operating loss	(2,190,736)	(2,998,585)
Other income (charge)		
Finance income	3,893	20,006
Finance expenses (note 19)	(543,916)	(207,974)
	(540,023)	(187,968)
Loss before Income Taxes	(2,730,759)	(3,186,553)
Income Taxes (note 21)	59,316	-
Net loss for the year	(2,671,443)	(3,186,553)
Loss attributable to:		
Shareholders of the Company	(2,671,443)	(3,186,521)
Non-controlling interest	-	(32)
	(2,671,443)	(3,186,553)
Loss per share		
Basic and diluted loss per share (note 15)	(0.07)	(0.08)

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

Xebec Adsorption Inc.

Consolidated Statements of Comprehensive Loss For the years ended December 31, 2016 and 2015

(expressed in Canadian dollars)

	2016 \$	2015 \$
Net loss for the year	(2,671,443)	(3,186,553)
Other comprehensive loss		
Cumulative translation adjustment	165,605	(499,136)
Comprehensive loss for the year	<u>(2,505,838)</u>	<u>(3,685,689)</u>
Attributable to:		
Shareholders of the Company	(2,505,838)	(3,685,657)
Non-controlling interest	-	(32)
	<u>(2,505,838)</u>	<u>(3,685,689)</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, 2016 and 2015

(expressed in Canadian dollars)

	Number		Amount							
	Common shares	Warrants	Share capital – Common shares and warrants \$	Contributed surplus \$	Accumulated other comprehensive loss \$	Deficit \$	Equity component of convertible debentures \$	Equity attributable to the shareholders of the Company \$	Non-controlling interest \$	Total \$
Balance – January 1, 2015	39,363,867	10,091,886	19,732,623	2,460,146	(606,685)	(20,914,588)	-	671,496	257,795	929,291
Net loss for the year	-	-	-	-	-	(3,186,521)	-	(3,186,521)	(32)	(3,186,553)
Other comprehensive loss	-	-	-	-	(499,136)	-	-	(499,136)	-	(499,136)
Comprehensive loss for the year	-	-	-	-	(499,136)	(3,186,521)	-	(3,685,657)	(32)	(3,685,689)
Expired warrants, November 2, 2015 (note 15)	-	(10,091,886)	(413,767)	413,767	-	-	-	-	-	-
Dissolution of a subsidiary	-	-	-	-	-	-	-	-	(257,763)	(257,763)
Stock-based compensation expense (note 16)	-	-	-	51,466	-	-	-	51,466	-	51,466
Balance – December 31, 2015	39,363,867	-	19,318,856	2,925,379	(1,105,821)	(24,101,109)	-	(2,962,695)	-	(2,962,695)
Balance – January 1, 2016	39,363,867	-	19,318,856	2,925,379	(1,105,821)	(24,101,109)	-	(2,962,695)	-	(2,962,695)
Net loss for the year	-	-	-	-	-	(2,671,443)	-	(2,671,443)	-	(2,671,443)
Other comprehensive loss	-	-	-	-	165,605	-	-	165,605	-	165,605
Comprehensive loss for the year	-	-	-	-	165,605	(2,671,443)	-	(2,505,838)	-	(2,505,838)
Issuance of convertible debentures (net of deferred tax liability of \$59,316 (note 21))	-	-	-	-	-	-	150,304	150,304	-	150,304
Stock-based compensation expense (note 16)	-	-	-	71,242	-	-	-	71,242	-	71,242
Balance – December 31, 2016	39,363,867	-	19,318,856	2,996,621	(940,216)	(26,772,552)	150,304	(5,246,987)	-	(5,246,987)

Accumulated other comprehensive 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, 2016 and 2015

(expressed in Canadian dollars)

	2016 \$	2015 \$
Cash flows from		
Operating activities		
Net loss for the year	(2,671,443)	(3,186,553)
Items not affecting cash		
Depreciation of property, plant and equipment (note 7)	94,785	107,275
Amortization of intangible assets (note 8)	76,837	152,618
Reversal of inventory writedown (note 6)	(17,420)	(47,934)
Impairment of intangible assets and goodwill	-	696,783
Gain on debt forgiveness	(657)	(190,092)
Government grant	(5,000)	(5,000)
Accretion and revaluation of government royalty program obligation	33,499	20,676
Accretion of the obligation arising from shares issued by a subsidiary (note 14)	350,575	92,866
Accretion of the convertible debenture (note 12 a))	16,327	-
Future income taxes (note 21 c))	(59,316)	-
Stock-based compensation expense (note 16)	71,242	51,466
Deferred rent	26,384	26,384
	<u>(2,084,187)</u>	<u>(2,281,511)</u>
Change in non-cash working capital balances related to operations (note 22)	(655,667)	1,016,550
	<u>(2,739,854)</u>	<u>(1,264,961)</u>
Investing activities		
Acquisition of property, plant and equipment	(55,605)	(72,261)
Acquisition of intangible assets	(28,894)	(26,564)
	<u>(84,499)</u>	<u>(98,825)</u>
Financing activities		
Decrease in restricted cash	-	214,592
Increase of bank loan	380,000	238,563
Proceeds from debenture units	1,000,000	-
Debenture issue costs	(51,928)	-
Increase from obligation under capital lease	42,120	-
Obligation arising from shares issued by a subsidiary	-	3,423,075
Repayment of long-term debt	-	(50,475)
Repayment of government royalty program obligation	-	(59,460)
	<u>1,370,192</u>	<u>3,766,295</u>
Net increase (decrease) in cash during the year	(1,454,161)	2,402,509
Cash – Beginning of year	2,717,965	1,008,421
Effect of exchange rate changes on cash	(175,212)	(692,965)
Cash – End of year	<u>1,088,592</u>	<u>2,717,965</u>
Additional information		
Interest paid	143,515	88,702

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

(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. The Company’s web site is www.xebec.com.

b) Liquidity risk assumption

The consolidated financial statements have been prepared on the basis of the going concern assumption, meaning that the Company will be able to realize its assets and discharge its liabilities in the normal course of operations. The Company has realized an operating loss of \$2,190,736, had cash outflows from operating activities of \$2,739,854 for the year ended December 31, 2016 and finished the year with cash amounting to \$1,088,592, negative working capital of \$1,205,820 and had access to credit facilities totalling \$750,000 of which \$755,000 has been used (see note 9). These conditions indicate the existence of a material uncertainty that may cast significant doubt regarding the Company ability to continue as a going concern. 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 2017 for which management believes the assumptions are reasonable. Achieving budgeted results is dependent on improving the volume of revenues in Canada, United States, Europe and China, delivering on sales and contract schedules, meeting expected overall operating margin levels and controlling general and administrative costs.

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 2017 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, 2016 and 2015

(expressed in Canadian dollars)

2 Basis of compliance and basis of preparation

The Company prepares its consolidated financial statements in accordance with International Financial Reporting Standards (IFRS).

These consolidated financial statements were approved for issue by the Board of Directors of the Company on April 24, 2017.

The consolidated financial statements have been prepared under the historical cost convention, except for where IFRS requires recognition at fair value.

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 consolidation

These consolidated financial statements include the accounts of the Company and its subsidiaries. Subsidiaries are entities controlled by the Company. Control is achieved when the Company:

- has power over the investee;
- is exposed, or has rights, to variable returns from its involvement with the investee; and
- has the ability to use its power to affect its returns.

The Company reassesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control listed above.

When the Company has less than a majority of the voting rights of an investee, it has power over the investee when the voting rights are sufficient to give it the practical ability to direct the relevant activities of the investee unilaterally. The Company considers all relevant facts and circumstances in assessing whether or not the Company's voting rights in an investee are sufficient to give it power, including:

- the size of the Company's holding of voting rights relative to the size and dispersion of holdings of the other vote holders;
- potential voting rights held by the Company, other vote holders or other parties;
- rights arising from other contractual arrangements; and
- any additional facts and circumstances that indicate that the Company has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

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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., which is 70% owned, Xebec Adsorption USA Inc. (Houston) and Xebec Adsorption Europe SARL which are wholly 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. The Company has the obligation to repurchase the Minority Shareholders' interest owned in Xebec Adsorption (Shanghai) Co. Ltd. under certain circumstances (see note 14). Therefore, the accounts of Xebec Adsorption (Shanghai) Co. Ltd. are consolidated at 100% and the Minority Shareholders' interest is presented as a financial liability in these consolidated financial statements.

Non-controlling interest represented equity interest in a subsidiary owned by an outside party until the dissolution on September 28, 2015. The share of net assets of subsidiaries attributable to non-controlling interest was presented as a component of equity. Its share of net loss and comprehensive loss was recognized directly in equity.

Changes in the Company's ownership interests in subsidiary that do not result in the Company losing control over the subsidiaries are accounted for as equity transactions or liability transactions depending on the conditions that these changes occurred. The carrying amounts of the Company's interests and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiaries.

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. Net realizable value is the estimated selling price for inventories less all estimated costs of completion and cost necessary to make the sale. Inventories are recorded net of any obsolescence provision.

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

Property, plant and equipment

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

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

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(expressed in Canadian dollars)

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 loss.

Identifiable intangible assets

The Company's intangible assets consist of customer relations and software. It also comprises capitalized development costs when the criteria for capitalisation are met. These assets are capitalized and amortized on a straight-line basis in the consolidated statement of loss over the period of their expected useful lives.

Customer relations were amortized over six years. Development costs related to a new line or segment are amortized over a period of five years. Software is amortized over a period of 3 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, or more frequently when there is an indication that the unit may be impaired, 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.

Xebec Adsorption Inc.

Notes to Consolidated Financial Statements

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(expressed in Canadian dollars)

Goodwill is allocated to each of the Company's cash-generating units (CGUs) for the purpose of impairment testing. The allocation is made to those CGUs that are expected to benefit from the synergies of the business combination in which the goodwill arose, identified according to operating segment.

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 instruments. 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
Obligation arising from shares issued by a subsidiary	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, if any.

Xebec Adsorption Inc.

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Finance income and expense are recognised by applying the effective interest rate, except for short-term receivable when the effect of discounting is immaterial.

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.

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 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.

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(expressed in Canadian dollars)

Basic and Diluted Loss per Share

Basic loss per share is calculated by dividing net loss for the year attributable to equity owners of the Company by the weighted average number of common shares outstanding during the year (note 15).

Diluted loss 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 convertible debentures, 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.

For the years ended December 31, 2016 and 2015, the potentially diluted loss per share was the same as the basic loss per share since the effect of the outstanding stock options, warrants and convertible debentures would have been ant dilutive.

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.

Xebec Adsorption Inc.

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Government grants

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

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

Leases

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

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

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

Stock-based compensation plans

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

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Income taxes

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

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

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

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

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

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 loss.

Segment reporting

The Company operates only one segment consisting in the design and manufacturing of filtration, purification, separation and dehydration equipment for gases and compressed air. This segment regroups five product lines and engineering services.

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

The following standards have been issued but are not yet effective:

In May 2014, the IASB issued IFRS 15, "Revenues from Contracts with Customers", to specify how and when to recognize revenue as well as requiring the provision of more information and relevant disclosure. IFRS 15 supersedes IAS 18, "Revenue", IAS 11, "Construction Contracts", and other revenue-related interpretations. The standard will be mandatory on January 1, 2018 for the Company with earlier adoption permitted. The Company is currently evaluating the impact of this standard on its consolidated financial statements.

In July 2014, the IASB amended IFRS 9, "Financial Instruments", to bring together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39, "Financial Instruments: Recognition and Measurement". The standard supersedes all previous versions of IFRS 9 and will be mandatory on January 1, 2018 for the Company with earlier application permitted. The Company is currently evaluating the impact of this standard on its consolidated financial statements.

In January 2016, IASB issued IFRS 16, "Leases", which specifies how an IFRS reporter will recognize, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value. Lessors continue to classify leases as operating or finance, with IFRS 16's approach to lessor accounting substantially unchanged from its predecessor, IAS 17. The standard will be mandatory for annual periods beginning on or after January 1, 2019. The Company is currently evaluating the impact of this standard 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 affect the Company's consolidated financial statements.

- 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.

- iv. Allowance for doubtful accounts

The Company reviews all amounts periodically for indications of impairment and the amounts impaired have been provided for as an allowance for doubtful accounts.

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v. Liquidity risk

The assessment of the Company's ability to continue as a going concern and to raise sufficient funds to pay for its ongoing operations expenditures, meets its liabilities for the ensuing year, involve significant judgment based on historical experience and other factors including expectation of future events that are believed to be reasonable under the circumstances.

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5 Trade and other receivables

	2016	2015
	\$	\$
Trade receivables	2,072,164	2,232,813
Other receivables	825,568	617,179
Less: Allowance for doubtful accounts	(448,291)	(412,833)
Trade and other receivables – net	<u>2,449,441</u>	<u>2,437,159</u>

Trade and other receivables are pledged as security for the credit facilities (see note 9, Bank loan).

6 Inventories

	2016	2015
	\$	\$
Raw materials	896,484	965,077
Work in progress	433,032	176,763
Inventories	<u>1,329,516</u>	<u>1,141,840</u>

Cost of goods sold includes cost of inventories amounting to \$4,037,908 in 2016 (2015 - \$5,113,363) including amounts of nil (2015 – nil) for the writedown of inventories to the lower of cost and net realizable value. During the current year, a reversal of a previous inventory writedown amounting to \$17,420 was recognized in inventory as the Company deems these parts recoverable for future orders.

Inventories are pledged as security for the credit facilities (see note 9, Bank loan).

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7 Property, plant and equipment

	Machinery and equipment ⁽¹⁾	Office furnitu re and equipment	Computers	Moulds	Vehicles	Total
	\$	\$	\$	\$	\$	\$
Cost						
Balance at December 31, 2014	484,754	143,672	232,642	163,431	35,984	1,060,483
Additions	46,533	333	25,395	-	-	72,261
Effect of movements in exchange rates	17,665	12,532	17,653	13,513	-	61,363
Balance at December 31, 2015	548,952	156,537	275,690	176,944	35,984	1,194,107
Additions	45,988	132	9,485	-	-	55,605
Effect of movements in exchange rates	(17,048)	(8,957)	(14,330)	(10,367)	-	(50,702)
Balance at December 31, 2016	577,892	147,712	270,845	166,577	35,984	1,199,010
Accumulated depreciation						
Balance at December 31, 2014	282,517	101,882	206,130	89,724	32,385	712,638
Depreciation	47,434	13,936	23,412	18,894	3,599	107,275
Effect of movements in exchange rates	12,476	11,249	15,986	12,088	-	51,799
Balance at December 31, 2015	342,427	127,067	245,528	120,706	35,984	871,712
Depreciation	50,011	10,427	16,933	17,414	-	94,785
Effect of movements in exchange rates	(10,700)	(8,588)	(13,011)	(9,726)	-	(42,025)
Balance at December 31, 2016	381,738	128,906	249,450	128,394	35,984	924,472
Carrying Amount						
At December 31, 2015	206,525	29,470	30,162	56,238	-	322,395
At December 31, 2016	196,154	18,806	21,395	38,183	-	274,538

Depreciation of \$94,785 (2015 – \$107,275) is included in the consolidated statement of loss: \$72,930 (2015 – \$78,671) in cost of goods sold; and \$21,855 (2015 – \$28,604) in selling and administrative expenses.

Property, plant and equipment are pledged as security for the credit facilities (see note 9)

⁽¹⁾ including equipment under finance lease. The cost of equipment under finance lease amount to \$45,988 and the accumulated depreciation amount to \$383.

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8 Intangible assets and goodwill

	Customer relations \$	Other Software \$	Internally generated Development costs \$	Total intangible assets \$	Goodwill \$
Cost					
Balance at December 31, 2014	1,900,000	270,894	298,485	2,469,379	142,616
Additions	-	26,564	-	26,564	-
Impairment	(1,900,000)	-	-	(1,900,000)	(142,616)
Effect of movements in exchange rates	-	16,195	-	16,195	-
Balance at December 31, 2015	-	313,653	298,485	612,138	-
Additions	-	28,404	490	28,894	-
Impairment	-	-	-	-	-
Effect of movements in exchange rates	-	(14,865)	-	(14,865)	-
Balance at December 31, 2016	-	327,192	298,975	626,167	-
Accumulated amortization					
Balance at December 31, 2014	1,266,666	254,376	29,040	1,550,082	-
Amortization for the year	79,167	13,754	59,697	152,618	-
Impairment	(1,345,833)	-	-	(1,345,833)	-
Effect of movements in exchange rates	-	14,488	-	14,488	-
Balance at December 31, 2015	-	282,618	88,737	371,355	-
Amortization for the year	-	17,140	59,697	76,837	-
Impairment	-	-	-	-	-
Effect of movements in exchange rates	-	(12,768)	-	(12,768)	-
Balance at December 31, 2016	-	286,990	148,434	435,424	-
Carrying amount					
At December 31, 2015	-	31,035	209,748	240,783	-
At December 31, 2016	-	40,202	150,541	190,743	-

Amortization of \$76,837 (2015 – \$152,618) is included in the consolidated statement of loss: \$16,277 (2015 – \$10,874) in cost of goods sold; and \$60,560 (2015 – \$141,744) in selling and administrative expenses.

In 2015, the Company carried out a review of its customer relations intangible assets relating to one single customer. This review led to the recognition of a full impairment charge of \$554,167 due to increased uncertainty regarding future orders from this customer.

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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The current operating environment has created considerable uncertainty as to the oil and gas activity that will be undertaken by several of the Company's customers and considerably increases the estimation uncertainty associated with the information used for its goodwill impairment test. Assumptions that are valid at the time of preparing the cash flow models may change significantly when new information becomes available. Considering these factors, management recorded a goodwill impairment charge of \$142,616 in 2015.

9 Bank loan

The Company has access to credit facilities in the amount of \$750,000 with Toronto-Dominion Bank of Canada which are guaranteed by Export Development Canada, and bear interest at the Toronto-Dominion's prime rate plus 3.0% (5.7%, 5.2% in 2015) per annum and are limited by certain margin requirements concerning trade and other receivables. These credit facilities were used up to \$755,000 as at December 31, 2016 (2015 – \$375,000).

The credit facilities are secured by a first ranking hypothec of \$2,000,000 on all movable property of the Company and are renewable annually.

The company has a guarantee facility of \$750,000 with Toronto-Dominion Bank of Canada.

10 Trade and other payables

	2016	2015
	\$	\$
Trade payables	2,893,639	3,001,773
Payables to related parties (note 25)	29,405	30,595
Other payables	80,650	72,804
Accrued liabilities	619,565	793,556
Trade and other payables	<u>3,623,259</u>	<u>3,898,728</u>

11 Deferred revenue

	2016	2015
	\$	\$
Deferred revenue on current contracts	<u>942,575</u>	<u>680,003</u>

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12 Long-term debt

a) Loans

	2016 \$	2015 \$
Obligation under a capital lease, repayable in monthly installments of \$1,607 including interest calculated at 13% maturing in October 2018, secured by equipment.	42,120	-
Unsecured Convertible debentures	754,780	-
Long-term debt	796,900	-
Less: Current portion	22,112	-
	<u>774,788</u>	<u>-</u>

On November 30, 2016, the Company has completed an Unsecured Convertible Debentures (“Debentures”) financing for aggregate gross proceeds of \$1,000,000. The Debentures will reach maturity on November 30, 2019 and bearing an annual interest rate of 9%, convertible into common shares of the Company at a price of \$0.15 per share. The unpaid interests are convertible at the highest price of \$0.15 per common share or the fair value of the common share at the request of the debenture holder.

The Company used the residual value method to allocate the principal amount of the Debenture between the liability and the equity component. Under this method, the value of the equity component of \$150,304 (net of deferred tax liability of \$59,316) was determined by deducting the fair value of the liability component from the principal amount of the financing. The fair value of the liability component was 790,380\$ computes as the present value of future principal and interest payments discounted at a rate of 19.50%. The effective interest method is used to measure the Debenture after the initial recognition.

No debentures were converted by holders as at December 31, 2016.

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b) Government royalty program obligation

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, 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, 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:

	2016 \$	2015 \$
Balance – Beginning of year	724,041	762,825
Accretion interest	33,499	20,676
Repayment	-	(59,460)
Balance – End of year	757,540	724,041
Current portion ⁽¹⁾	757,540	243,207
	-	480,834

⁽¹⁾ With the new amendment of January 2017, as describe after, the current portion will be reduced to \$79,505.

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

In 2015, a new amendment to this agreement was reached changing the preceding payments terms from monthly payments of \$24,500 to monthly payments 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.

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In February 2017, a new amendment to this agreement was reached changing the preceding payments terms from monthly payments of \$24,500 to monthly payments of:

- \$29,505 upon execution
- \$5,000 starting from March 1, 2017 to January 1, 2018
- \$7,000 starting from February 1, 2018 to January 1, 2019
- \$8,000 starting from February 1, 2019 to January 1, 2020
- \$10,000 starting from February 1, 2020 to January 1, 2021
- \$15,000 starting from February 1, 2021 to October 1, 2022
- \$20,000 on November 1, 2022 and December 1, 2022
- And the balance of \$22,540 on January 1, 2023.

13 Provisions

	Provision for contingencies	Warranty costs	Total provision
	(a)	(b)	
	\$	\$	\$
At December 31, 2015	505,461	213,113	718,574
Additional provisions	-	27,179	27,179
Unused amount reversed	(220,000)	(147,064)	(367,064)
Used during the year	(124,929)	(35,701)	(160,630)
At December 31, 2016	<u>160,532</u>	<u>57,527</u>	<u>218,059</u>
Current portion of provisions	<u>160,532</u>	<u>48,601</u>	<u>209,133</u>
Non-current provisions	<u>-</u>	<u>8,926</u>	<u>8,926</u>

(a) Provision for contingencies

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

(b) 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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14 Obligation arising from shares issued by a subsidiary

In September 2015, as a result of a Sino-foreign equity joint venture agreement, Xebec Adsorption (Shanghai) Co. Ltd., a subsidiary of Xebec Adsorption Inc. (“Xebec”), issued 1,714,285 common shares, representing a 30% participation, to Shanghai Chengyi New Energy Venture Capital Co. Ltd. (28.26%), an investment subsidiary of Shanghai based Shenergy Group, Shanghai Zhiyi Enterprise Management Consulting Co. Ltd. (0.1%) and Shanghai Liuhuan Investment Co. Ltd. (1.64%), a company held by a group of employees of Xebec Adsorption (Shanghai) Co. Ltd., (collectively the “Minority Shareholders”) for a net cash consideration of \$3,423,075 (RMB 16,370,515).

Pursuant to this agreement, Xebec has the obligation to repurchase the Minority Shareholders’ interest in Xebec Adsorption (Shanghai) Co. Ltd., for a consideration of no less than the initial investment and annualized return of 10% if a) the achievement of specific financial targets were not achieved in any given year prior to December 31, 2020, or b) should the Minority Shareholders not divest by December 31, 2020 and should the Minority Shareholders exercise their put option with respect to a) or b) as mentioned above.

Xebec recorded the proceeds from this transaction, as a financial liability in these consolidated financial statements. The obligation to repurchase and the related annualized return is presented under “Obligation arising from shares issued by a subsidiary”. The conversion of the financial liability denominated in the functional currency of our subsidiary Xebec Adsorption (Shanghai) Co. Ltd. (RMB) will be converted at the exchange rate at the end of each reporting period with gain and losses presented in the statement of income under “Gain/Loss on conversion of shares issued by a subsidiary”.

	2016	2015
	\$	\$
Balance – Beginning of year	3,583,808	-
Initial obligation recorded, net of issuance costs	-	3,423,075
Accretion interest	350,575	92,866
Effect of exchange rate change on obligation	(352,248)	67,867
Balance – End of year	3,582,135	3,583,808
Current portion	-	-
	<u>3,582,135</u>	<u>3,583,808</u>

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15 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 shares, without par value.
- b) Share purchase warrants

There were no warrants issued in 2016. Information that summarizes the activity related to the Company's share purchase warrants for the year ended December 31, 2015:

	<u>2015</u>
	Weighted average exercise price \$
Balance – Beginning of year	10,091,886
Expired	<u>(10,091,886)</u>
Balance – End of year	<u>-</u>

- c) Loss per share

- i. Basic

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

	2016	2015
	\$	\$
Net loss attributable to shareholders of the Company	(2,671,443)	(3,186,521)
Weighted average number of common shares in issue	39,363,867	39,363,867
Basic loss per share	<u>(\$0.07)</u>	<u>(\$0.08)</u>

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16 Stock-based compensation expense

The stock option 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 Plan, a fixed number of 5,904,580 common shares are available for grant. As at December 31, 2016, 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 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:

	2016		2015	
	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
Outstanding – Beginning of year	4,390,337	0.16	5,838,402	0.16
Granted	1,500,000	0.05	-	-
Cancelled	(25,000)	7.29	(1,448,065)	0.14
Expired	(10,000)	0.22	-	-
Outstanding – End of year	5,855,337	0.11	4,390,337	0.16
Exercisable – End of year	5,855,337	0.11	3,707,003	0.17

As at December 31, 2016, options outstanding and exercisable are as follows:

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2016					
Exercise price range \$	Number of options	Options outstanding		Options exercisable	
		Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
0.05 – 0.10	3,060,000	3.96	0.08	3,060,000	0.08
0.12 – 0.16	2,558,065	4.34	0.13	2,558,065	0.13
0.22	237,272	1.61	0.22	237,272	0.22
	5,855,337	4.03	0.11	5,855,337	0.11

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:

	2016		2015	
	Non-employees	Employees	Non-employees	Employees
Dividend yield	0%	0%	-	-
Exercise price	\$0.05	\$0.05	-	-
Risk-free interest rate	1.15%	1.15%	-	-
Estimated life	7 years	7 years	-	-
Expected volatility	81%	81%	-	-
Stock price	\$0.06	\$0.06	-	-

In 2016, 1,100,000 options were granted to employees at a weighted average fair value of \$0.05. No options were granted to employees in 2015.

In 2016, 400,000 options were granted to non-employees at a weighted average fair value of \$0.05. No options were granted to non-employees in 2015.

Compensation expense with respect to these options amounted to \$47,655 for employees and \$23,587 for non-employees for the year ended December 31, 2016 (2015 – \$51,466 and \$none).

The underlying expected volatility was determined by reference to historical data of the Company.

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17 Expenses by nature

	2016	2015
	\$	\$
Employee salaries and benefits	5,062,355	5,565,338
Material	4,037,908	5,113,363
Rent and repairs and maintenance	669,899	660,728
Travel expenses	525,420	580,180
Professional fees	473,566	552,760
Office expense	280,466	214,999
Subcontracting costs	274,235	215,896
Depreciation and amortization	171,622	259,894
Stock-based compensation	71,242	51,466
Other	207,653	553,611
	<u>11,774,366</u>	<u>13,768,235</u>

18 Research and development expenses

	2016	2015
	\$	\$
Employee salaries and benefits	129,432	452,299
Subcontracting costs	(44,229)	44,229
Material	8,983	7,968
Professional fees	59,476	3,271
Travel expenses	368	799
Government grants	(5,000)	(5,000)
Research and development tax credits	(6,334)	(138,201)
	<u>142,696</u>	<u>365,365</u>

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19 Finance expenses

	2016	2015
	\$	\$
Interest and bank charges	43,286	33,815
Interest on long-term debt	-	92
Interest charges	100,229	47,250
Accretion of convertible debenture	16,327	-
Accretion and revaluation of government royalty program obligation (note 12 (b))	33,499	33,951
Accretion of the obligation arising from shares issued by a subsidiary (note 14)	350,575	92,866
	<u>543,916</u>	<u>207,974</u>

20 Compensation of key management

Compensation awarded to key management included:

	2016	2015
	\$	\$
Salaries and short-term employee benefits	966,834	1,356,909
Stock-based compensation	71,242	51,466
	<u>1,038,076</u>	<u>1,408,375</u>

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

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21 Income taxes

Effective tax rate

The income tax expense attributable to earnings differs from the amounts computed by applying the combined federal and provincial income tax rate of 26,9% (26,9% in December 31, 2015) to earnings before income taxes as a result of the follows:

	2016	2015
	\$	\$
Loss before income taxes	(2,730,759)	(3,186,553)
Expected income tax recovery	(734,574)	(857,183)
Tax expense at combined statutory rate		
Increase (decrease) in income taxes resulting from:		
Temporary difference not recorded	206,432	708,689
Difference in foreign tax rate	23,043	-
Stock base compensation	19,164	13,844
Change of deferred tax rates	337,351	4,145
Foreign exchange on consolidation	4,639	-
Expired losses	36,663	-
Other	48,146	130,505
	<u>(59,136)</u>	<u>0</u>

Composition of deferred income taxes in the income statement

	2016	2015
	\$	\$
Inception and reversal of temporary differences	(602,919)	(712,834)
Temporary difference not recorded	206,432	708,689
Change in deferred tax rate	337,351	4,145
	<u>(59,136)</u>	<u>0</u>

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Movement of deferred income tax in 2016

	2015 \$	P&L	Capital- actions	Equity component	2016 \$
Debentures	-	5,161	-	(59,136)	(53,975)
Non capital losses	-	53,975	-	-	53,975
Total	-	59,136	-	(59,136)	-

As at December 31, 2016, deductible timing differences for which the company has not recognized deferred tax asset are as follows:

	Federal \$	Quebec \$	Chine \$	USA \$
Property and equipment	938,985	938,985	-	-
Intangible assets	59,079	59,079	-	-
Scientific research and development expenses	24,502,892	24,500,175	-	-
Capital losses carried forward	219,247	219,247	-	-
Operating losses carried forward	55,350,875	57,925,868	1,783,721	493,442
Other	694,496	694,496	-	-
	81,765,574	84,337,850	1,783,721	493,442

The ability to realize the tax benefits is dependent upon a number of factors, including the future profitability of operations. Deferred tax assets are recognized only to the extent that it is probable that sufficient taxable profits will be available to allow the asset to be recovered. Accordingly, some deferred tax assets have not been recognized, these deferred tax assets not recognized equal an amount of \$22,597,127.

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As at December 31, 2015, deductible timing differences for which the company has not recognized deferred tax asset are as follows:

	Federal	Quebec	Chine	USA
	\$	\$	\$	\$
Property and equipment	872,952	57,396	-	-
Intangible assets	-	-	-	-
Scientific research and development expenses	25,058,780	25,058,780	-	-
Capital losses carried forward	24,600	24,600	-	-
Operating losses carried forward	53,907,013	55,566,059	1,153,725	558,405
Other	910,636	910,636	-	-
	<u>80,773,981</u>	<u>81,617,471</u>	<u>1,153,725</u>	<u>558,405</u>

The ability to realize the tax benefits is dependent upon a number of factors, including the future profitability of operations. Deferred tax assets are recognized only to the extent that it is probable that sufficient taxable profits will be available to allow the asset to be recovered. Accordingly, some deferred tax assets have not been recognized, these deferred tax assets not recognized equal an amount of \$26,567,318.

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As at December 31, 2016, the Company has non-capital tax losses, which are available to reduce income taxes in future years and expired as follows:

	Federal	Québec	Chine	USA
2036	1,518,000	1,508,000	-	-
2035	1,329,000	1,329,000	-	493,000
2034	-	2,635,000	-	-
2033	326,000	326,000	-	-
2032	546,000	495,000	-	-
2031	443,000	433,000	-	-
2030	12,362,000	12,362,000	-	-
2029	7,284,000	7,296,000	-	-
2028	10,824,000	10,824,000	-	-
2027	6,795,000	6,795,000	-	-
2026	7,229,000	7,229,000	-	-
2025	6,695,000	6,695,000	-	-
2024	-	-	-	-
2022	-	-	-	-
2021	-	-	885,000	-
2020	-	-	-	-
2019	-	-	-	-
2018	-	-	550,000	-
2017	-	-	348,000	-
	<u>55,351,000</u>	<u>57,927,000</u>	<u>1,783,000</u>	<u>493,000</u>

The Company has scientific research and experimental development expenses of approximately \$24,503,000 (2015 – \$25,059,000) 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, 2016, the Company also has investment tax credits of approximately \$5,659,000 (2015 – \$5,678,500) available to offset future Canadian federal income taxes payable. The potential benefit of the investment tax credits has not been recognized in the accounts.

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22 Supplemental Cash flow information

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

	2016	2015
	\$	\$
Decrease (increase) in assets:		
Trade and other receivables	(12,282)	244,152
Inventories	(170,256)	575,444
Investment tax credits receivable	69,723	(67,676)
Other current assets	(29,441)	237,385
Increase (decrease) in liabilities:		
Trade, other payables and accrued liabilities	(256,911)	(126,967)
Deferred revenues	244,014	(135,007)
Provisions and deferred rent	(500,514)	289,219
	<u>(655,667)</u>	<u>1,016,550</u>

23 Commitments

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

As at December 31, 2016	Payment Due by Period			
	1 year	2 - 5 years	Beyond 5 years	Total
	\$	\$	\$	\$
Operating leases	<u>506,772</u>	<u>1,424,270</u>	<u>1,943,509</u>	<u>3,874,551</u>

Operating leases include building and various equipment leases.

The operating lease expenses for the year ended December 31, 2016 amounted to \$480,027 (\$462,796 for the year ended December 31, 2015)

24 Contingent liabilities

The Company was party to various ongoing and pending litigation during the year 2016, that were all resolved as of December 31, 2016, along with other contingencies arising out of the normal course of business. As a result, management has provisioned for settlements an amount of \$143,400 which is included in current portion of provision (note 13).

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25 Related party transactions

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

	2016 \$	2015 \$
Marketing and professional service expenses paid to companies controlled by members of the immediate family of an officer	141,201	139,824
Sales to an entity controlled by a subsidiary manager	-	882,900

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

26 Capital management

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

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

	2016 \$	2015 \$
Cash	(1,088,592)	(2,717,965)
Bank loan	755,000	375,000
Long-term debt	796,900	-
Government royalty program obligation (note 12 (b))	757,540	724,041
Obligation arising from shares issued by a subsidiary (note 14)	3,582,135	3,583,808
	<hr/>	<hr/>
Equity	4,802,983 (5,246,987)	1,964,884 (2,962,695)
	<hr/>	<hr/>
	(444,004)	(997,811)

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

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27 Segmented information

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

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

	2016 \$	2015 \$
Revenue		
United States	4,022,932	3,066,409
Canada	2,397,870	2,942,691
Republic of China	847,323	2,681,035
Singapore	739,826	1,640,521
Other	1,579,430	1,019,970
	<u>9,587,381</u>	<u>11,350,626</u>

Revenue summarized by product line is as follows:

	2016 \$	2015 \$
Product line		
Natural gas dryers	2,577,629	5,906,344
Compressed gas filtration	4,656,732	3,831,755
Biogas purification	2,232,102	1,090,843
Associated gas	-	68,850
Engineering services	-	8,934
Air dryers	120,918	443,900
	<u>9,587,381</u>	<u>11,350,626</u>

Included in revenues arising from direct sales of natural gas dryers and biogas purification equipment (2016: \$3,453,773 and 2015: \$6,671,361) are revenues of approximately \$2,447,848 (2015: \$3,017,030) which arose from sales to the Group's largest customer. No other single customers contributed more than 10% to the Group's revenue for both 2016 and 2015.

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

	2016 \$	2015 \$
Non-current assets		
Canada	305,071	431,173
Asia	111,480	127,353
United States	48,730	4,652
	<u>465,281</u>	<u>563,178</u>

28 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, 2016

	<u>Loans and receivables</u>		<u>Other financial liabilities</u>	
	Carrying amount \$	Fair value \$	Carrying amount \$	Fair value \$
Cash	1,088,592	1,088,592	-	-
Trade and other receivables	2,323,611	2,323,611	-	-
Other current assets	100,819	100,819		
Bank loan	-	-	755,000	755,000
Trade, other payables and accrued liabilities	-	-	3,118,064	3,118,064
Convertible debentures			754,780	754,780
Government royalty program obligation	-	-	757,540	757,540
Obligation arising from shares issued by a subsidiary	-	-	3,582,135	3,582,135

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	December 31, 2015		Other	
	Loans and receivables		financial liabilities	
	Carrying amount	Fair value	Carrying amount	Fair value
	\$	\$	\$	\$
Cash	2,717,965	2,717,965	-	-
Trade and other receivables	2,437,159	2,437,159	-	-
Bank loan	-	-	375,000	375,000
Trade, other payables and accrued liabilities	-	-	3,898,728	3,898,728
Government royalty program obligation	-	-	724,041	724,041
Obligation arising from shares issued by a subsidiary	-	-	3,583,808	3,583,808

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 (classified in level 2 of the fair value hierarchy): 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 (classified in level 2 of the fair value hierarchy): 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.
- Obligation arising from shares issued by a subsidiary (classified in level 2 of the fair value hierarchy): Fair value of the obligation arising from shares issued by a subsidiary has been calculated by computing an annualized return of 10% on the initial consideration
- The Company's financial instruments that are measured subsequent to initial recognition at fair value and financial instruments measured at amortized cost for which the fair value is disclosed 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).

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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 \$448,291 (2015 – \$412,833) 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 expense amounted to \$75,995 in 2016 (2015 – \$164,820). As at December 31, 2016, the Company's three largest trade debtors accounted for 33% (13%, 10% and 10%) of the total trade and other receivables balance (2015 – 41% (20%, 12% and 9%)).

Details of trade and other receivables were as follows:

	2016	2015
	\$	\$
Current trade receivables	949,511	1,092,498
Trade receivables past due by:		
1–30 days	82,998	160,342
31–60 days	277,213	244,750
61–90 days	102,155	159,546
Over 90 days	660,287	575,677
Total trade receivables	2,072,164	2,232,813
Allowance for doubtful accounts	(448,291)	(412,833)
Other receivables	825,568	617,179
Total trade and other receivable	<u>2,449,441</u>	<u>2,437,159</u>

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

	<u>2016</u>	<u>2015</u>
At beginning of period	(412,833)	(217,021)
Provision for impairment	(75,995)	(303,171)
Unused amounts reversed	40,537	107,359
At ending of period	<u>(448,291)</u>	<u>(412,833)</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 loss. Management believes that a 10% change in exchange rates would be reasonably possible and that the impact on net loss of such a change would be approximately \$113,473 for 2016 (2015 – \$147,555). As at December 31, 2016, 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>2016</u>	
	US dollar	Euro
Cash	604,037	135
Trade and other receivables	434,461	39,280
Trade and other payables	(114,296)	(114,365)
	<u>924,202</u>	<u>(74,950)</u>
Equivalent in Canadian dollars	<u>1,240,926</u>	<u>(106,196)</u>

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	2015	
	US dollar	Euro
Cash	897,796	17,507
Trade and other receivables	369,866	39,483
Trade and other payables	(174,732)	(81,653)
	<u>1,092,930</u>	<u>(24,663)</u>
Equivalent in Canadian dollars	<u>1,512,615</u>	<u>(37,066)</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, 2016, the short-term bank loan amounted to \$755,000 (2015 – \$375,000). If the interest rate on the bank debt had been 50 basis points higher (lower), related to the bank loan as at December 31, 2016, net loss would have been \$3,295 (2015 – \$1,338) lower (higher).

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(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:

	2016				
	Carrying amount \$	Contractual cash flow \$	0 to 12 months \$	13 to 24 months \$	Thereafter \$
Financial liabilities					
Bank loan	755,000	755,000	755,000	-	-
Trade, other payables and accrued liabilities	3,118,064	3,118,064	3,118,064	-	-
Government royalty program obligation	757,540	757,540	757,540	-	-
Obligation under capital lease	42,120	38,561	19,281	16,067	-
Convertible debentures Obligation arising from shares issued by a subsidiary	754,780	1,270,247	90,247	90,000	1,090,000
	3,582,135	3,582,135	-	-	3,582,135
	<u>9,009,639</u>	<u>9,521,547</u>	<u>4,740,132</u>	<u>106,067</u>	<u>4,672,135</u>
					2015
	Carrying amount \$	Contractual cash flow \$	0 to 12 months \$	13 to 24 months \$	Thereafter \$
Financial liabilities					
Bank loan	375,000	375,000	375,000	-	-
Trade and other payables	3,105,172	3,105,172	3,105,172	-	-
Accrued liabilities	793,556	793,556	793,556	-	-
Government royalty program obligations	724,041	757,540	250,500	507,040	-
Obligation arising from shares issued by a subsidiary	3,583,808	3,583,808	-	-	3,583,808
	<u>8,581,577</u>	<u>8,615,076</u>	<u>4,524,228</u>	<u>507,040</u>	<u>3,583,808</u>

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Contractual interest amounts on floating interest rates are established based on the spot rates as at the statement of financial position dates.

The Company's development is financed through a combination of borrowing under the existing credit facilities and the issuance of debt and equity.

Subsequent event

On December 12 2016, the Company contracted a facility loan with Export Development Canada ("EDC") for an amount of \$2,000,000. The facility bears an interest of prime rate plus 6.3% annum. This interest is payable every month. This amount is available in four advances. On December 31 2016, according to certain conditions, the balance of the loan was nil since all the conditions were not met. The Company received the first advance payment in January 2017.