Consolidated Financial Statements of

# BIOREM INC.

Years ended December 31, 2010 and 2009

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# Independent Auditors' Report

To the Shareholders of BIOREM Inc.

We have audited the accompanying consolidated financial statements of BIOREM Inc. ("the Entity"), which comprise the balance sheets as at December 31, 2010 and December 31, 2009 and the statements of operations and comprehensive loss, statements of shareholders' equity, and statements of cash flows for the years then ended, and notes, comprising 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 Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

*Auditors' 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 our 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, we consider 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 opinions.

*Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of BIOREM Inc. as at December 31, 2010 and December 31, 2009, and its consolidated results of operations and consolidated cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants, Licensed Public Accountants

April 12, 2011
Waterloo, Canada

# BIOREM INC.

Consolidated Balance Sheets

December 31, 2010 and 2009

| | | 2010 | | 2009 |
|---|---|---|---|---|
| **Assets** | | | | |
| Current assets: | | | | |
| Cash and short-term investments | $ | 831,343 | $ | 4.030.814 |
| Restricted cash | | 500,000 | | - |
| Accounts receivable (note 15c) | | 5,010,779 | | 2,897,842 |
| Unbilled revenue (note 1i) | | 4,601,515 | | 3,448,529 |
| Inventory (note 3) | | 768,706 | | 649,374 |
| Prepaid expenses and deposits | | 87,927 | | 65,984 |
| Investment tax credits recoverable | | 150,000 | | 100,000 |
| | | 11,950,270 | | 11,192,543 |
| Long-term accounts receivable | | 394,000 | | - |
| Plant and equipment (note 4) | | 1,020,264 | | 1,011,228 |
| Investment tax credits recoverable (note 7) | | - | | 250,000 |
| Technology, patents and other assets (note 5) | | 1,015,261 | | 1,267,671 |
| Goodwill | | 1,428,000 | | 1,428,000 |
| | $ | 15,807,795 | $ | 15,149,442 |
| **Liabilities and Shareholders' Equity** | | | | |
| Current liabilities: | | | | |
| Accounts payable | $ | 3,818,041 | $ | 1,588,199 |
| Accrued liabilities | | 3,781,927 | | 2,228,169 |
| Unearned revenue (note 1i) | | 782,742 | | 287,031 |
| Current portion of long-term debt (note 6) | | 1,833,128 | | - |
| | | 10,215,838 | | 4,103,399 |
| Long-term debt (note 6) | | - | | 2,498,227 |
| Shareholders' equity: | | | | |
| Common shares (note 8) | | 13,201,212 | | 13,201,212 |
| Contributed surplus | | 1,622,527 | | 1,440,605 |
| Deficit | | (9,231,782) | | (6,094,001) |
| | | 5,591,957 | | 8,547,816 |
| Commitments (note 14) | | | | |
| | $ | 15,807,795 | $ | 15,149,442 |

See accompanying notes to consolidated financial statements.

# BIOREM INC.

Consolidated Statements of Operations and Comprehensive Loss

Years ended December 31, 2010 and 2009

| | 2010 | 2009 |
|---|---|---|
| Revenue | $ 17,359,556 | $ 18,878,218 |
| Cost of goods sold | 12,275,592 | 11,290,303 |
| | 5,083,964 | 7,587,915 |
| Expenses (income): | | |
| Sales and marketing | 3,560,860 | 3,620,060 |
| Research and development (note 10) | 1,758,772 | 1,191,540 |
| Government assistance (note 10) | (1,133,609) | (995,397) |
| General and administration | 2,260,102 | 2,153,917 |
| Stock option compensation (note 9) | 181,922 | 231,202 |
| Total operating expenses | 6,628,047 | 6,201,322 |
| Earnings (loss) before the following | (1,544,083) | 1,386,593 |
| Amortization of plant and equipment | 333,272 | 218,121 |
| Amortization of technology, patents and other assets | 252,410 | 258,218 |
| Accretion of deferred financing costs | 143,468 | 91,768 |
| Accretion of warrant costs | 191,433 | 119,268 |
| Loss (gain) on foreign exchange | 33,060 | 808,829 |
| Write down of long term tax asset (note 7) | 250,000 | - |
| Interest - short -term | 7,555 | 10,727 |
| Interest - long-term | 382,500 | 382,500 |
| Total other expenses | 1,593,698 | 1,889,431 |
| Loss and comprehensive loss | $ (3,137,781) | $ (502,838) |
| Earnings per share: (note 11) | | |
| Basic | $ (0.26) | $ (0.04) |
| Diluted | (0.26) | (0.04) |

See accompanying notes to consolidated financial statements.

# BIOREM INC.

Consolidated Statements of Shareholders' Equity

Years ended December 31, 2010 and 2009

| | Share Capital | Contributed Surplus | Deficit | Total |
|---|---|---|---|---|
| Balance as at January 1, 2009 | $ 13,171,212 | $ 1,209,403 | $ (5,591,163) | $ 8,789,452 |
| Loss for the year ended December 31, 2009 | - | - | (502,838) | (502,838) |
| Stock option compensation | - | 231,202 | - | 231,202 |
| Common shares issued | 30,000 | - | - | 30,000 |
| Balance as at December 31, 2009 | 13,201,212 | 1,440,605 | (6,094,001) | 8,547,816 |
| Loss for the year ended December 31, 2010 | - | - | (3,137,781) | (3,137,781) |
| Stock option compensation (note 9) | - | 181,922 | - | 181,922 |
| Balance as at December 31, 2010 | $ 13,201,212 | $ 1,622,527 | $ (9,231,782) | $ 5,591,957 |

See accompanying notes to consolidated financial statements.

# BIOREM INC.

Consolidated Statements of Cash Flows

Years ended December 31, 2010 and 2009

| | 2010 | 2009 |
|---|---|---|
| Cash provided by (used in): | | |
| Operations: | | |
| Loss for the year | $ (3,137,781) | $ (502,838) |
| Items not involving cash: | | |
| Amortization of plant and equipment | 333,272 | 218,121 |
| Amortization of technology, patents and other assets | 252,410 | 258,218 |
| Accretion of deferred financing costs | 143,468 | 91,768 |
| Accretion of warrant costs | 191,433 | 119,268 |
| Stock option compensation | 181,922 | 231,202 |
| Write down of long term tax asset | 250,000 | - |
| Issuance of common shares | - | 30,000 |
| | (1,785,276) | 445,739 |
| Net changes in non cash operating working capital (note 12) | (71,886) | 1,677,572 |
| Cash provided by (used in) operations | (1,857,163) | 2,123,311 |
| Investing: | | |
| Purchase of plant and equipment | (342,308) | (291,784) |
| Cash used in investing activities | (342,308) | (291,784) |
| Financing: | | |
| Payment of long-term debt | (1,000,000) | - |
| Financing costs | - | - |
| Cash used in financing activities | (1,000,000) | - |
| Increase (decrease) in cash | (3,199,471) | 1,831,527 |
| Cash and short-term investments, beginning of year | 4,030,814 | 2,199,287 |
| Cash and short-term investments, end of year | $ 831,343 | $ 4,030,814 |

See note 13 for supplemental cash flow information.

See accompanying notes to consolidated financial statements.

BIOREM Inc. was incorporated on December 18, 2003 as a Capital Pool Company of the TSX Venture Exchange Inc. ("Exchange") under the laws of the Province of Ontario. BIOREM Technologies Inc. is incorporated under the laws of the Province of Ontario and BIOREM Environmental Inc. is incorporated under the laws of the State of Delaware. BIOREM Inc. and its subsidiaries (collectively the "Company") design and manufacture a comprehensive line of high efficiency air pollution control systems that are used to eliminate odorous and harmful contaminants.

## 1. Significant accounting policies:

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and reflect the following policies:

(a) Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries BIOREM Technologies Inc. and BIOREM Environmental Inc.

(b) Cash and short-term investments:

The Company considers deposits in banks and short-term investments with original maturities of three months or less as cash and cash equivalents.

(c) Inventory

Inventory is stated at the lower of cost and net realizable value. Cost is determined on a weighted average basis.

(d) Plant and equipment:

Plant and equipment is recorded at acquisition cost less any applicable government assistance or investment tax credits. Amortization is provided using the following methods and annual rates:

| Asset | Basis | Rate |
|---|---|---|
| Research equipment | Declining balance | 20% |
| Production equipment | Declining balance | 20% |
| Office furniture | Declining balance | 20% |
| Computer hardware | Straight-line | 3 years |
| Computer software | Straight-line | 3 years |
| Leasehold improvements | Straight-line | 10 years |

## 1. Significant accounting policies (continued):

(e) Technology, patents and other assets:

Technology, patents and other assets are recorded at acquisition cost. Amortization is provided using the following method and annual rates:

| Asset | Basis | Rate |
|---|---|---|
| Technology | Straight-line | 10 years |
| Patents | Straight-line | 10 years |
| Trademarks | Straight-line | 10 years |
| Customer lists | Straight-line | 10 years |

(f) Goodwill:

Goodwill represents the excess of the purchase price consideration over the fair value of net assets of the acquired business. Goodwill is not subject to amortization but is subject to an annual assessment for impairment by applying a fair-value test. Any impairment in the value of goodwill would be charged to income.

(g) Income taxes:

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment. The Company recognizes a tax benefit when it is more likely-than-not based on the Company's best estimate of the amount that will ultimately be realized. A change to those estimates could impact the income tax provision and net income.

(h) Foreign currency translation:

The Canadian dollar is the Company's functional and reporting currency. Monetary assets and liabilities denominated in foreign currency are translated using the exchange rate in effect at the balance sheet date, non-monetary assets and liabilities denominated in foreign currency are translated using the historical exchange rate and revenues and expenses at the rates of exchange prevailing when the transaction occurred.

**1. Significant accounting policies (continued):**

(h) Foreign currency translation (continued):

The Company's foreign operation, located in the United States is deemed to be an integrated foreign operation and, therefore, its financial statements are translated using the temporal method. Under this method, all asset, liability, revenue and expense items are translated at the exchange rate in effect at the transaction date. At the balance sheet dates, monetary assets and liabilities are adjusted to reflect the year end exchange rate. The gain or loss resulting from translation is included in the determination of income for the current period.

(i) Revenue recognition:

Revenues include the sales of biofilter systems, Biosorbens™ media, service and license fees. For contracts of short duration, revenue is recorded when products are shipped or services are performed.

Certain of the Company's contracts are long-term in nature. The Company recognizes revenue on long-term contracts using the percentage of completion method, based on costs incurred relative to the estimated total contract costs. Contract price and cost estimates are reviewed periodically as the work progresses and adjustments proportionate to the percentage of completion are reflected in the period when such estimates are revised. Current provisions are made for all known or anticipated losses on contracts which have not been completed. When the Company recognizes revenue, it also records a provision for potential warranty claims and commissioning expenditures. It bases the warranty provision on the specific warranty terms and historical claims experience.

Unbilled revenue represents work that has been recognized as revenue under the percentage-of-completion method but not yet invoiced to clients. Unearned revenue represents amounts billed in excess of revenue earned.

Service revenues are derived from service agreements commencing after the warranty period expires. Revenue is recognized on these agreements ratably over the term of the agreements. Revenues from other services are recognized when the services are performed.

(j) Research and development:

Research and development costs, other than capital expenditures, are expensed as incurred unless they meet generally accepted accounting principles for deferral. Research and development expenditures are reduced by investment tax credits and related government grants. Investment tax credits for scientific research and experimental development are recognized in the period qualifying expenditures are incurred and there is reasonable assurance that they will be realized.

**1. Significant accounting policies (continued):**

(k) Stock-based compensation:

The Company has a stock-based compensation plan, which is described in note 10.

The Company accounts for stock based awards in accordance with CICA Handbook Section 3870, *"Stock-based Compensation and Other Stock-Based Payments"*. Under this Section, the fair value of all stock-based awards granted is estimated using the Black-Scholes model and are recorded in operations over their vesting period of the award.

(l) Use of estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates. Estimates are reviewed on a regular basis and, as adjustments become necessary, they are reported in income in the periods in which they become known. The assets and liabilities which require management to make significant estimates and assumptions in determining carrying values include accounts receivable, inventory, investment tax credits recoverable, plant and equipment, technology, patents and other assets, goodwill, accounts payable, warranty and accrued liabilities and future income taxes. In addition, significant estimates are required in determining the percentage of completion and the corresponding recognition of revenue in relation to the Company's long-term contracts and determination of stock option compensation expense.

(m) Transaction costs:

Transaction costs are incremental costs directly related to the acquisition of a financial asset or the issuance of a financial liability. The Company incurs transaction costs primarily through the issuance of debt and classifies these costs with the related debt. These costs are amortized using the effective interest method over the life of the related debt instrument. The Company recognizes as an asset or liability all embedded derivatives that are required to be separated from their host contracts.

(n) Financial instruments:

The Company has classified its financial instruments as follows; cash and cash equivalents are classified as held-for-trading and measured at fair value, accounts receivable and unbilled revenue are classified as loans and receivables and measured at amortized cost, accounts payable and accrued liabilities, unearned revenues and contract advances, and long-term debt are classified as other liabilities and measured at amortized cost.

(o) Government Grants

Government grants and forgivable loans are recorded when there is reasonable assurance that the Company has complied with, and will continue to comply with, all the necessary conditions to obtain the grants and loans. Grants and forgivable loans received are treated as a reduction of property and equipment costs and operating expenses based on the conditions of the grant and the underlying basis for which the amounts are earned.

## 2. Changes in accounting policies:

**International Financial Reporting Standards**

The Company will adopt International Financial Reporting Standards effective January 1, 2011.

## 3. Inventory:

Inventory consists of raw materials and manufactured media carried at the lower of cost and net realizable value. The total amount of purchased materials and components included in cost of goods sold for the year was $9,580,000 (2009 - $8,885,000).

## 4. Plant and equipment:

| | | | 2010 |
|---|---|---|---|
| | Cost | Accumulated amortization | Net book value |
| Research equipment | $ 136,512 | $ 79,836 | $ 56,676 |
| Production equipment | 1,205,569 | 582,519 | 623,050 |
| Office equipment | 564,080 | 355,756 | 208,324 |
| Leasehold improvements | 353,981 | 221,767 | 132,214 |
| | $ 2,260,142 | $ 1,239,878 | $ 1,020,264 |

| | | | 2009 |
|---|---|---|---|
| | Cost | Accumulated amortization | Net book value |
| Research equipment | $ 136,512 | $ 66,448 | $ 70,064 |
| Production equipment | 1,120,290 | 601,914 | 518,376 |
| Office equipment | 507,727 | 249,873 | 257,854 |
| Leasehold improvements | 353,981 | 189,047 | 164,934 |
| | $ 2,118,510 | $ 1,107,282 | $ 1,011,228 |

Amortization of plant and equipment was $333,272 (2009 - $218,121)

## 5. Technology, patents and other assets:

| | | | 2010 |
|---|---|---|---|
| | Cost | Accumulated amortization | Net book value |
| Technology | $ 1,426,416 | $ 852,816 | $ 573,600 |
| Patents | 359,528 | 222,318 | 137,210 |
| Trademark | 61,500 | 33,568 | 27,932 |
| Customer lists | 615,000 | 338,481 | 276,519 |
| | $ 2,462,444 | $1,447,183 | $ 1,015,261 |

| | | | 2009 |
|---|---|---|---|
| | Cost | Accumulated amortization | Net book value |
| Technology | $ 1,426,416 | $ 709,416 | $ 717,000 |
| Patents | 359,528 | 180,953 | 178,575 |
| Trademark | 61,500 | 27,418 | 34,082 |
| Customer lists | 615,000 | 276,986 | 388,014 |
| | $ 2,462,444 | $1,194,773 | $ 1,267,671 |

Amortization on technology, patents and other assets was $252,409 (2009 - $258,218).

## 6. Long-term debt:

| | 2010 | 2009 |
|---|---|---|
| 12.75% debenture due October 31, 2011 | $ 2,000,000 | $ 3,000,000 |
| Less: | | |
| Deferred financing costs | (71,898) | (215,367) |
| Deferred warrant costs | (94,974) | (286,406) |
| | $ 1,833,128 | $ 2,498,227 |

On October 31, 2008, the Company secured long-term financing in the form of a $3,000,000 debenture bearing interest at 12.75% per annum payable monthly. On December 31, 2009 the Company entered into an extension agreement whereby the maturity date of the debenture has been extended from the original date of October 31, 2010 to October 31, 2011. Certain other terms contained within the debenture were also amended.

The amended terms include an option to repay the debenture anytime after November 1, 2010 without penalty to the Company. In December 2010, the Company made a payment of $1,000,000 against the outstanding principal balance. The debenture is secured by a general security agreement covering all assets of the Company and is subject to meeting certain financial covenants each quarter as amended in the extension agreement.

## 6. Long-term debt (continued):

In relation to the debenture, the Company issued 1,153,846 special warrants which are exercisable into 1,153,846 share purchase warrants, each of which is exercisable to acquire one common share of the Company upon payment of the exercise price of $0.65 per share. The share purchase warrants expire October 31, 2013.

The Company is subject to certain financial and operating covenants. The Company was not in compliance with certain covenants at December 31, 2010. Subsequent to December 31, 2010, the lender agreed in writing to waive its right to take action under the debenture agreement as a result of such non-compliance at December 31, 2010. In the event of a future covenant violation the Company's lender may increase the interest rate on the debenture to 18.00%. Based on the current covenants, it is likely that the Company will be in violation of the covenants in the first quarter of 2011. Management is working with its lender to amend the covenant terms but there is no certainty that the amendments will be obtained.

Using the Black-Scholes model, the fair value of the warrants was calculated to be $423,461. The fair value of the warrants together with the financing costs of $320,951 related to the loan were deferred and are accreted into income using the effective interest method over 36 months. The offset to the fair value of the warrants was recorded to contributed surplus.

The following were the assumptions used to derive the Black-Scholes model value of $0.367 per warrant:

| | |
|---|---|
| Risk-free interest rate | 2.8 % |
| Expected life | 5 years |
| Expected volatility | 65 % |
| Expected dividends | – |

## 7. Income taxes:

Income tax expense differs from the amount that would be computed by applying the combined Canadian federal and provincial statutory tax rate of 31.0% (2008 – 33.0%) to earnings before income taxes. The reasons for the differences and related tax effects are as follows:

| | 2010 | 2009 |
|---|---|---|
| Computed tax expense | $ (973,000) | $ (166,000) |
| Non-deductible expenses for tax purposes | 57,000 | 86,000 |
| Tax rate differential in foreign subsidiary | (78,000) | (17,000) |
| Change in tax rates | 86,500 | 82,000 |
| Valuation allowance | 830,000 | 15,000 |
| Write off of investment tax credits | 77,500 | - |
| | $ - | $ - |

The tax effects of temporary differences that give rise to significant portions of the future tax asset at December 31, 2010 and December 31, 2009 are presented below:

| | 2010 | 2009 |
|---|---|---|
| Future tax assets: | | |
| Loss carry forwards available in future years | $ 1,201,000 | $ 655,000 |
| Scientific research and experimental development expenditures not yet deducted for tax purposes | 915,000 | 652,000 |
| Provisions not yet deducted for tax purposes | 317,000 | 180,000 |
| Financing costs | 79,000 | 123,000 |
| | 2,512,000 | 1,610,000 |
| Future tax liabilities: | | |
| Capital assets - differences in net book value and undepreciated capital cost | (378,000) | (306,000) |
| | 2,134,000 | 1,304,000 |
| Less: valuation allowance | (2,134,000) | (1,304,000) |
| Long-term portion of future tax assets | $ - | $ - |

As at December 31, 2010, the Company has income tax losses available to reduce future years' taxable income, which expire as follows:

| | Canada | U.S. | Total |
|---|---|---|---|
| 2025 | $ - | $ 205,000 | $ 205,000 |
| 2026 | - | 360,000 | 360,000 |
| 2027 | 980,000 | 520,000 | 1,500,000 |
| 2028 | - | 150,000 | 150,000 |
| 2029 | - | 95,000 | 95,000 |
| 2030 | 30,000 | 1,150,000 | 1,180,000 |
| Indefinite | 3,000,000 | - | 3,000,000 |
| | $ 4,010,000 | $ 2,480,000 | $ 6,490,000 |

## 7. Income taxes (continued):

In addition, the Company has Canadian investment tax credits available to be applied against future income taxes payable in the amount of approximately $1,422,000, which expire as follows:

| | |
|---|---|
| 2014 | $ 78,000 |
| 2015 | 260,500 |
| 2026 | 148,000 |
| 2027 | 205,000 |
| 2028 | 260,000 |
| 2029 | 243,000 |
| 2030 | 227,500 |
| | $ 1,422,000 |

A full valuation allowance has been set up for the investment tax credit asset.

## 8. Share capital

| | 2010 | 2009 |
|---|---|---|
| Authorized: | | |
| Unlimited number of common shares | | |
| Issued: | | |
| 12,057,246 common shares (2009 – 12,057,246) | $ 13,201,212 | $ 13,201,212 |

## 9. Stock-based compensation

The Company uses a stock option plan to attract and retain key employees, senior executives and directors. Under the terms of the plan, which received shareholder approval, the aggregate number of shares reserved for issuance is fixed at 1,796,745. The maximum number of shares reserved for issuance pursuant to options granted to any one person is limited to 5% of the common shares outstanding at the time of the grant. The stock option exercise price is the closing market price of the Company's common shares on the day prior to the date of the grant. Options granted under the plan may be exercised during a period not exceeding ten years from the date of the grant, subject to termination upon the optionee ceasing to be a director, senior executive or employee of the Company and have vesting periods of at least three years. Options issued under the plan are non-transferable.

## 9. Stock-based compensation (continued):

i) The weighted average fair value of options granted in 2010 and 2009 have been calculated based on the following assumptions:

| | 2010 | 2009 |
|---|---|---|
| Weighted average fair value of each option | $ 0.30 | $ 0.31 |
| Assumptions: | | |
| Expected volatility | 40% | 50% - 70% |
| Risk free interest rate | 2.4% | 1.7% - 2.5% |
| Expected life in years | 10 years | 10 years |
| Expected dividend yield | 0% | 0% |

ii) The following table summarizes the continuity of options issued under the plan:

| | 2010 | | 2009 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price | Number of options | Weighted average exercise price |
| Outstanding, beginning of year | 1,438,333 | $ 1.45 | 1,322,667 | $ 1.59 |
| Options forfeited | (103,167) | 0.64 | (36,334) | 2.87 |
| Options expired | (104,831) | 3.04 | - | - |
| Granted during the year | 234,000 | 0.68 | 152,000 | 0.45 |
| Outstanding, end of year | 1,464,335 | $ 1.19 | 1,438,333 | $ 1.45 |
| Exercisable, end of year | 901,495 | $ 1.25 | 705,656 | $ 1.85 |

Options outstanding and exercisable at December 31, 2010:

| Options Outstanding | | | | Options Exercisable | |
|---|---|---|---|---|---|
| Number outstanding | Exercise price | Weighted average exercise price | Remaining life in years | Number exercisable | Weighted average exercise price |
| 58,500 | 2.50 - 2.75 | 2.57 | 0.32 | 58,500 | 2.57 |
| 781,000 | 1.11 - 1.75 | 1.54 | 5.90 | 581,000 | 1.41 |
| 322,835 | 0.68 - 0.90 | 0.74 | 8.63 | 101,331 | 0.83 |
| 302,000 | 0.33 – 0.48 | 0.42 | 8.29 | 160,664 | 0.46 |
| 1,464,335 | | $ 1.19 | 6.77 | 901,495 | $ 1.25 |

## 10. Research and development expenses:

| | 2010 | 2009 |
|---|---|---|
| Expenses incurred | $ 1,758,772 | $ 1,191,540 |
| Less: | | |
| Government funding | (924,516) | (780,957) |
| Investment tax credits | (209,093) | (214,440) |
| | $ 625,163 | $ 196,143 |

The Company is eligible for Federal investment tax credits at a rate of 20% of qualifying scientific research and experimental development expenditures conducted in Canada, in addition to investment tax credits or deductions available from provincial jurisdictions. Federal investment tax credits are only available to the Company to be applied against future income taxes payable.

During 2009, the Company was approved for financial assistance with the Ministry of Research and Innovation – Innovation Demonstration Fund Program in the form of a forgivable loan. The loan bears interest at 3.98% per annum, payable at maturity, and is due March 31, 2015. The loan is secured by a general security agreement over all assets of the Company that are subordinate to long-term debt. The principal and interest is to be forgiven pro rata based on certain milestones having been reached. The loan is to support the Company's development and demonstration of a potential long-term solution for sewage treatment plant odour control. The Company receives contributions of 50% of the specified costs of the project to a maximum of $1,189,018. The Company has recorded $348,035 (2009 - $542,000) as an offset to expense and has received $973,000 (2009 - $609,000) to December 31, 2010.

During 2010, the Company was approved for financial assistance with the Ministry of Research and Innovation – Innovation Demonstration Fund Program in the form of a forgivable loan. The loan bears interest at 3.97% per annum, payable at maturity, and is due June 30, 2015. The loan is secured by a general security agreement over all assets of the Company that was subordinate to long-term debt. The principal and interest is to be forgiven pro rata based on certain milestones having been reached. The loan is to support the Company's development and demonstration of a potential long-term solution for sewage treatment plant odour control. The Company receives contributions of 50% of the specified costs of the project to a maximum of $1,226,000. The Company has recorded $412,653 as an offset to expense and has received $nil to December 31, 2010.

In 2008 the Company was approved for funding through the Industrial Research Assistance Program (IRAP). The funding is to support the Company's research and development efforts for the treatment of volatile organic compounds. The Company receives contributions of 50% of the specified costs to a maximum of $404,120. The Company has recorded $104,295 (2009 - $176,995) as an offset to expense and has received $374,673 (2009 - $284,166) to December 31, 2010.

During 2010, the Company was approved for funding through the Industrial Research Assistance Program (IRAP). The funding is to support the Company's sales and research into the Biogas conditioning market throughout North America. The Company receives contributions of 50% of the specified costs to a maximum of $50,000. The Company has recorded $35,489 as an offset to expense and has received $nil to December 31, 2010.

## 11. Earnings per share:

The computations for basic and diluted earnings per share are as follows:

| | | 2010 | | 2009 |
|---|---|---|---|---|
| Loss | $ | (3,137,781) | $ | (502,838) |
| Average number of common shares outstanding: | | | | |
| Basic | | 12,057,246 | | 12,006,417 |
| Effect of stock options | | - | | - |
| Diluted | | 12,057,246 | | 12,006,417 |
| Earnings per share: | | | | |
| Basic | $ | (0.26) | $ | (0.04) |
| Diluted | | (0.26) | | (0.04) |

## 12. Net change in operating assets and liabilities:

| | 2010 | 2009 |
|---|---|---|
| Cash provided by (applied to): | | |
| Accounts receivable | $ (2,112,937) | $ 2,521,185 |
| Restricted cash | (500,000) | - |
| Long term receivable | (394,000) | - |
| Unbilled revenue | (1,152,986) | 361,182 |
| Inventory | (119,331) | (62,402) |
| Prepaid expenses | (21,943) | 529,670 |
| Investment tax credits recoverable | (50,000) | 76,104 |
| Accounts payable | 2,229,842 | (875,363) |
| Accrued liabilities | 1,553,758 | 175,281 |
| Unearned revenue | 495,711 | (1,048,085) |
| | $ (71,886) | $ 1,677,572 |

## 13. Supplemental cash flow information:

| | 2010 | 2009 |
|---|---|---|
| Cash received for: | | |
| Income taxes | $ - | $ - |
| Cash paid for: | | |
| Interest | 393,227 | 393,227 |
| Income taxes | - | - |

## 14. Commitments:

The Company is committed under operating leases for the rental of a building, property and computer equipment. The aggregate minimum annual commitments for the next five years are as follows:

| | |
|---|---|
| 2011 | $ 148,747 |
| 2012 | 77,124 |
| 2013 | 77,124 |
| 2014 | 77,124 |
| 2015 | 25,708 |
| Total future minimum lease payments | $ 405,827 |

Operating lease expense in 2010 was $181,473 (2009 - $164,513).

**15. Financial instruments:**

a) Fair values:

The carrying value of cash, accounts receivable, accounts payable and accrued liabilities approximate their fair value due to the relatively short periods to maturity of these items or because they are receivable or payable on demand.

b) Foreign exchange risk:

As at December 31, 2010, the Company's cash and short-term investments, accounts receivable and unbilled revenue denominated in US$ amounted to $5,345,533. Accounts payable and accrued liabilities and unearned revenue denominated in US$ amounted to $2,381,125. A 10% strengthening of the Canadian dollar against the US$ at December 31, 2010 would have decreased equity and net income for the year by $296,440.

The Company operates internationally, which gives rise to the risk that cash flows may be adversely impacted by exchange rate fluctuations. The Company enters into forward exchange contracts to hedge its foreign currency exposure on export sales. At December 31, 2010, the Company holds 2 contracts to sell CD, one contract to sell CD $150,000 at an exchange rate of 1.011 and one contract to sell CD $100,000 at an exchange rate of 1.0125. As at December 31, 2010, the exchange rate was 0.9946. Changes in the fair market value of the contracts are recognized in the statement of earnings. These financial instruments are subject to normal credit standards, financial controls, risk management and monitoring processes.

c) Credit risk:

Credit risk arises from the possibility that the Company's customers may experience difficulty and be unable to fulfill their contractual obligations. In order to manage its risk, the Company has adopted credit policies that include regular review and follow up of outstanding project receivable balances. The majority of the Company's invoicing is for municipal projects. The Company's accounts receivable are not subject to significant concentration of credit risk and the Company has not incurred any significant bad debts to date.

As at December 31, 2010, 25% of the Company's accounts receivable balance is over 90 days past due versus 42% at December 31, 2009. .Additionally, 14% of the accounts receivable balances over 90 days is attributable to holdbacks associated with project completion compared to 30% in 2009. During 2010 the allowance for doubtful accounts receivable was increased by $155,916 (2009 - $nil). The amount of allowance at the beginning of the year was $16,000 (2009 – $16,000) and at the end of the year was $171,917 (2009 - $16,000).

**15. Financial instruments (continued):**

(d) Liquidity risk:

Liquidity risk is the risk that the Company will not be able to meet its obligations as they become due. The Company's budget and cash flow forecasts indicate it has and will generate sufficient cash flows to meet its obligations during 2011, taking into consideration cash and cash equivalents available to the Company as at December 31, 2010.

**16. Segmented information:**

Management has determined that the Company operates in one dominant industry segment, which involves the manufacture and sale of industrial machinery.

The Company's revenue and capital assets breaks down geographically as follows:

| | Revenue | | Capital assets [1] | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Canada | $ 6,977,007 | $ 6,548,404 | $ 1,351,374 | $ 1,421,185 |
| United States | 7,893,377 | 9,543,155 | 2,112,151 | 2,285,714 |
| Other | 2,489,172 | 2,786,659 | - | - |
| Total | $ 17,359,556 | $ 18,878,218 | $ 3,463,525 | $ 3,706,899 |

[1] Includes plant and equipment, goodwill, technology, patents and other assets

In 2010, one customer accounted for 16% of total revenue (2009 – one customer accounted for 16% of total revenue). Two customers accounted for 26% of accounts receivable as at December 31, 2010 (2009 - one customer accounted for 16%).

**17. Capital management**:

The policy of the Board of Directors is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The Board monitors the demographic spread of the shareholders, the return of capital, which the Company defines as total shareholders' equity, and the level of dividends to ordinary shareholders.

**18. Comparative figures:**

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted for the current year.