2010 Annual Report

Fiscal Year ended
June 30, 2010

For additional information:
Investor Relations
investor@h2oinnovation.com

Trading symbols:
TSX Venture: HEO
Alternext: MNEMO: ALHEO

Annual reports and press releases are accessible on
our Website: *www.h2oinnovation.com* and on SEDAR

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VISION, MISSION & PROFILE

OUR VISION

To become the best in North America, working through consulting engineers, at customizing water treatment systems based on comprehensive analytical and strong technical capabilities aimed at maximizing the efficiency, performance and longevity of systems and by this, create sustained and growing value for our shareholders.

OUR MISSION

To provide safe, integrated and customized water treatment solutions in a changing environment.

OUR PROFILE

With 10 years of experience developing water treatment solutions, H_2O Innovation designs, develops, produces, and integrates state-of-the-art custom-built water treatment systems for the production of drinking water and industrial process water, the reclamation of water, and the treatment of wastewater in the municipal, commercial, institutional, industrial, oil & gas, mining, and energy markets. Additionally, H_2O Innovation offers complete operating and maintenance solutions for membrane filtration and reverse osmosis systems. H_2O Innovation has approximately 90 employees and eight offices including three manufacturing plants in Canada and the United States. H_2O Innovation is a founding partner of H_2O Innovation India, a joint venture with Chembond Chemicals of Mumbai, India,

OUR HISTORY

2010

- Revenues reach $27.7 M
- Signing of a sales representation agreement with 3M Purification Inc. for the U.S. and Canadian oil & gas and automobile assembly markets.
- Creation of H_2O Innovation India Limited, a joint venture with Chembond Chemicals Limited. Headquartered in Mumbai, India, the joint venture is dedicated to providing water treatment systems and maintenance services to the Indian industrial and commercial markets for the production of boiler feed and process water, for industrial wastewater reclamation and reuse, as well as for wastewater treatment.

2009

- Revenues reach $31.2 M
- Acquisition of Professional Water Technologies

Brings a proprietary line of specialty patent-pending sustainable membrane pre-treatment and maintenance products as well as a 12,000 sq. ft. manufacturing and office facility.

- Acquisition of Itasca Systems Inc.

H_2O Innovation adds expertise in process water treatment as well as a 37,000 sq. ft. manufacturing and assembly facility.

2008

- Revenues reach $10.8 M
- Acquisition of Wastewater Technology Inc.

This acquisition brings an expertise in wastewater treatment with patented bioreactor and membrane bioreactor technologies.

- Acquisition of Sigma Environmental Solutions Inc.

This transaction increases the Company’s sales force in Western Canada and strengthens its offer to the oil and mining industry.

2007

- Revenues reach $7 M
- Listing on the NYSE Euronext Alternext Euronext exchange.

H_2O Innovation becomes the first North American company admitted to this exchange and attracts the attention of European sustainable development funds.

- Acquisition of Membrane Systems Corporation

H_2O Innovation gains expertise in seawater desalination and onsite construction of high capacity nanofiltration (NF) and reverse osmosis (RO) membrane filtration plants.

2006

- Revenues reach $3.6 M

2005

- Acquisition of Biosor Technologies Inc.

The wastewater portfolio is strengthened with the BIOSOR™ technology for high load effluent treatment.

2002

- Acquisition of OxydH_2O and Systèmes Bioflo Inc.

H_2O Innovation adds a water purification component through the RBR, BIOTOWER, and BIO-FOSSE technologies.

2001

- Listing on the CDNX (TSX-V) exchange.

H_2O Innovation becomes Quebec's first publicly traded water treatment company.

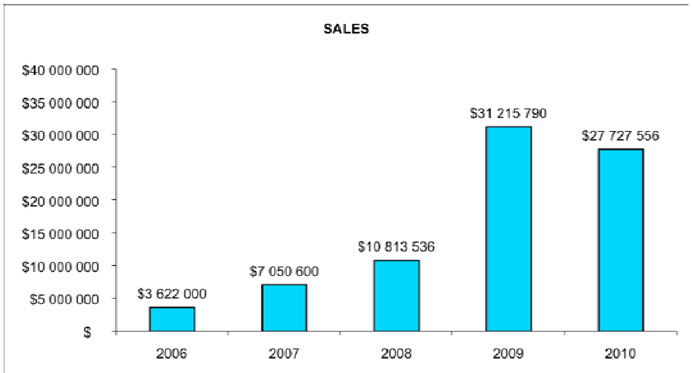
2000

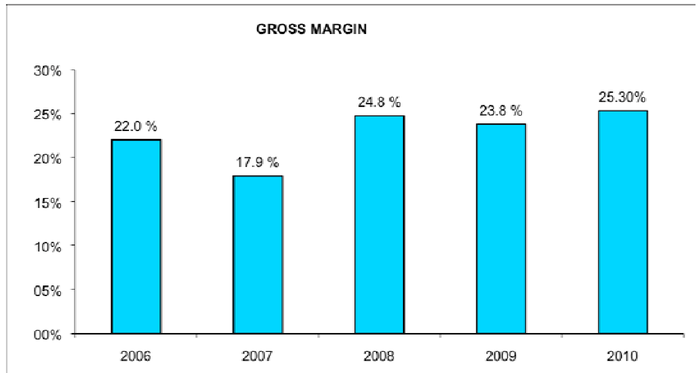
- CAN$3 million in funding and acquisition of Darv-Eau Inc.

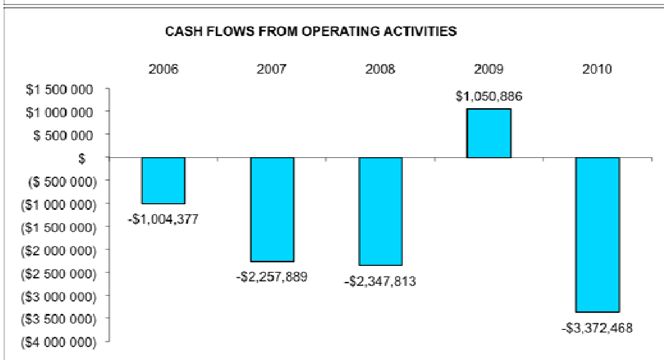
Provides membrane filtration expertise (NF, RO) as well as a 65,000 sq. ft. manufacturing and assembly plant.

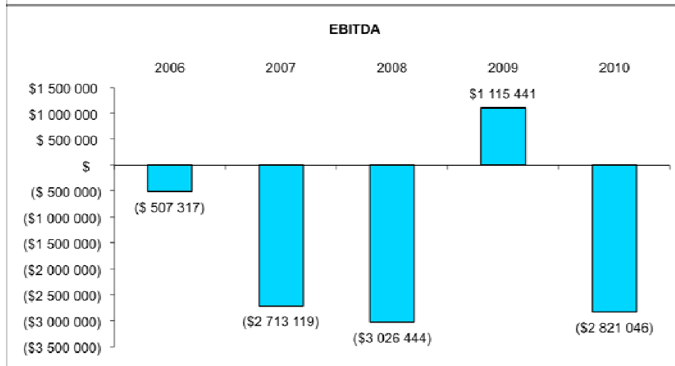
- Company founded in Quebec City, Canada

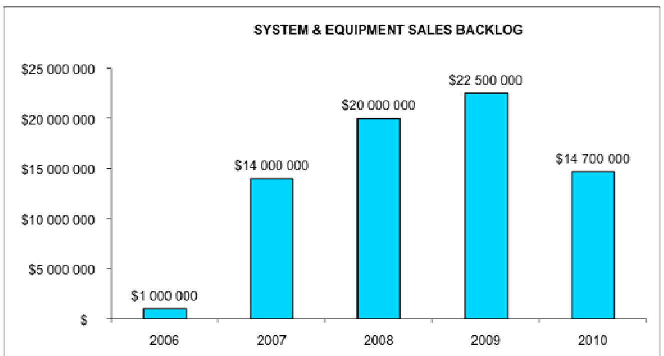
FINANCIAL HIGHLIGHTS

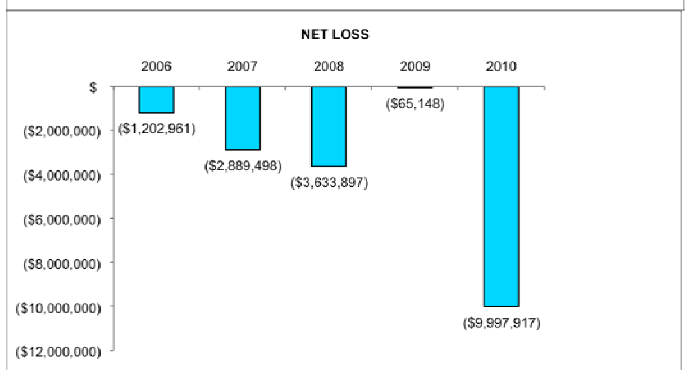












THE FOLLOWING DATA HAS BEEN SELECTED FROM THE COMPANY'S AUDITED ANNUAL CONSOLIDATED FINANCIAL STATEMENTS. YEARS ENDED JUNE 30.

(IN DOLLARS, EXCEPT THE NUMBER OF SHARES) [1]

	2006	2007	2008	2009	**2010**
Sales	3,622,101	7,050,612	10,813,536	31,215,790	**27,727,556**
EBITDA[2]	(507,317)	(2,451,081)	(3,026,444)	1,115,441	**(2,821,046)**
Net loss	(1,202,961)	(2,889,498)	(3,633,897)	(65,148)	**(9,997,917)**
Cash flows from operations	(1,004,377)	(2,257,889)	(2,347,813)	1,050,886	**(3,372,468)**
Cash and cash equivalents	(7,182,516)	8,757,980	9,549,698	5,594,406	**2,672,375**
Held-for-trading investments	0	7,883,871	2,330,807	2,021,070	**1,266,751**
Working capital	8,211,241	20,331,678	15,385,301	13,411,365	**7,540,077**
Total debt	0	0	0	6,167,142	**3,543,498**
Shareholders' equity	11,558,049	25,444,511	24,074,411	36,116,626	**28,276,526**
PER SHARE					
Net earnings	(0.112)	(0.117)	(0.100)	(0.001)	**(0.181)**
Cash flows from operations	(0.094)	(0.091)	(0.065)	0.022	**(0,061)**
Weighted average number of outstanding common shares	10,729,896	24,677,665	36,285,225	47,722,705	**55,160,147**

[1] All amounts mentioned in this report are in Canadian dollars, unless otherwise stated.
[2] Earnings before interests, taxes, depreciation and amortization (EBITDA) is a performance indicator that is not determined in accordance with Canadian generally accepted accounting principles and is not intended as an alternative measure of net earnings. Because EBITDA may not be calculated identically by all companies, the Company's result may not be directly comparable to similarly titled measures of other companies.

BOARD OF DIRECTORS

PHILIPPE GERVAIS
Chairman of the Board
H_2O Innovation Inc.
Senior Consultant
The Capital Hill Group

FRÉDÉRIC DUGRÉ
President and CEO
H_2O Innovation Inc.

JOHN G. BOOTH
Lawyer & Associate
JAS Financial Products

ANDRÉ DUQUENNE
President
T2ic inc.

RICHARD A. HOEL
Private investor and attorney Shareholder
Winthrop & Weinstine

ÉLAINE C. PHÉNIX
President Phénix Capital inc.

LISA HENTHORNE
Chief Technology Officer
Water Standard

BOARD COMMITEES

AUDIT COMMITTEE

Élaine C. Phénix (President), Richard Hoel, Philippe Gervais, André Duquenne
Composed of four directors, including three non-related, independent directors, the audit committee is responsible for the oversight of the Company's main accounting and financial reporting processes as well as the internal and external accounting personnel.

GOVERNANCE, REMUNERATION AND RISKS COMMITTEE

Élaine C. Phénix (President), André Duquenne, John G. Booth
Composed of three non-related, independent directors, the governance, remuneration and risks committee is responsible for examining matters relating to the appointment and compensation of executive officers of the Company, including the compensation of the President and CEO; the committee then makes recommendations to the Board. The committee is responsible for assessing the contribution, performance, size and effectiveness of the Board and its committees and is responsible for identifying potential candidates for membership on the Board. It reviews the executive officer succession planning process and periodically reviews the Company's corporate governance practices and ensures that they are compliant.

MESSAGE TO SHAREHOLDERS

DEAR SHAREHOLDERS,

Although our financial results for the 2010 fiscal year fell short of the financial objectives we had targeted, major strides were made during this year, putting H_2O Innovation in a **BETTER POSITION TODAY** than before. During this period, we expanded our sales representation network, signed and implemented a sales representation agreement with 3M Purification Inc., established a joint venture in India, merged our U.S. operating subsidiaries, and successfully integrated Professional Water Technologies ("PWT"), which we acquired at the end of the previous fiscal year. Our client offering has never been as **COMPLETE, RELEVANT AND NOTICED** by the industry since the company was founded 10 years ago.

Results in brief

During the fiscal year ended June 30, 2010, sales totaled $27.7 million, down from the $31.2 million in sales registered during the 2009 fiscal year. Our gross margin for fiscal 2010 has nonetheless increased, improving to 25.3% from 23.8% in fiscal 2009. EBITDA (earnings before interest, tax, depreciation, and amortization) for fiscal 2010 were ($2,821,046), compared to $1,115,441 for fiscal 2009. The net loss for fiscal 2010 was ($9,997,917) ($0.181 per share), including a non monetary loss related to the write-off of intangible assets, a goodwill impairment charge and future income tax recovery, totalling respectively ($1,763,861), ($4,916,000) and $634,800, compared to a net loss of ($65,148) ($0.001 per share) for fiscal 2009.

Results impacted by recession

This fiscal year unfolded under shadow of a global recession that was particularly severe in the United States, our top geographical market. This recession forced businesses, local governments, and public institutions to drastically cut back on their investments in capital assets and equipment. Some of them delayed projects while many other companies and municipalities downright cancelled their investment projects.

Government programs for major investments intended to jumpstart the economy have been somewhat successful, and have helped slow the recession in the United States and initiate the first signs of growth here in Canada. However, this effect has been uneven and felt at varying speeds across all industries. The implementation of these recovery programs took time and their effects were slow to be felt.

In the water treatment industry, the visible effects of government recovery programs did not appear until midway through our 2010 fiscal year. At the start of the third quarter, we experienced an increase in bidding activity and business development. Simultaneously, some municipal projects halted by local administrations at the very start of the recession were resumed, some of them thanks to funding from economic recovery programs. The high level of bidding activity and business development held steady in the second half of fiscal 2010 and has continued up to date in fiscal 2011.

Just as in the municipal field, manufacturing, processing, energy, and resource companies and a number of industry clusters have significantly reduced their capital equipment investments since the start of the recession. This affected us throughout fiscal 2010, leading to a sharp decrease in our sales of industrial water treatment systems.

Goodwill impairment charge and write-off of intangible assets

Due to this sudden and prolonged decrease in our operations in the industrial sector, we reevaluated the book value of our intangible assets and goodwill mainly related to the acquisition of Itasca Systems, Inc. in July 2008. The result of this reevaluation was respectively a $1.8 and $4.9 million decrease in the book value of our intangible assets and goodwill, which increased the net loss for the fiscal year. The net loss for the fiscal year totaled $10 million, including a non-monetary loss of $6.1 million related to the goodwill impairment charge, write-off of intangible assets and future income tax recovery.

The industrial sector finally shows recovery signs

In the weeks following the end of the fiscal year, the industrial sector showed the first signs of recovery in terms of investment, particularly in the resource and energy sectors, where we are very active and where **OUR EXPERTISE IS OFTEN CALLED UPON**.

A more comprehensive commercial offer

During this year, we have made significant progress on our growth strategy, both in terms of bringing depth to our products and services and of strengthening our market position.

The acquisition in late June 2009 and the successful integration of PWT—a business that develops, manufactures, and markets pretreatment and maintenance solutions for membrane filtration systems—and the consolidation of PWT's office with our San Diego branch; the merger of our U.S. operating subsidiaries; our sales representation agreement with 3M Purification in the U.S. and Canada; the creation of H_2O Innovation India Limited (our joint venture in India); and the implementation of a cost reduction program – all these achievements have considerably **STRENGTHENED H_2O INNOVATION'S BUSINESS POSITION** compared to the start of the year while bringing us closer to positive cash flows and net income.

Our hybrid offer is a catalyst for sales

Today H_2O Innovation is **STRONGER** and more agile, boasting a more comprehensive line of products and services designed to cover a broader spectrum of client needs. This progress not only strengthens our position in the market but also acts as a catalyst: thanks to our **HYBRID OFFER**, our water treatment systems sales generate sales of maintenance and cleaning solutions, and vice-versa; our long list of North American reference projects lends credibility to the development of our joint venture in India, which in turn increases our **INTERNATIONAL COMPETITIVENESS** as a sourcing and assembly platform.

Growth in the consumables and services sales

The performance of our PWT unit and our consumables and services sales team has been exceptional all year long, leading to growth in spite of the economic climate. The strengthening of this growth centre through the acquisition and the **SUCCESSFUL INTEGRATION** of PWT at the start of the year not only benefited the results for this fiscal year but will also, we feel, bear fruit in the years to come.

During the integration process, not only were we successful at keeping all of PWT's existing clients, but we also **ADDED NEW CLIENTS** and increased revenues. In addition to generating higher gross margins than those generated by systems sales, the sale of consumables and services enables us to build **CLOSE RELATIONSHIPS** with our clientele, putting us first in line to identify new opportunities for system sales.

In fiscal 2011, our after-sales service, consumables, and maintenance solutions sales team will also implement a development plan designed to boost on one side national sales by adding services and resources, and on the other side international sales by adding distributors for our PWT product line. Many other **SYNERGIES REMAIN** to be captured, notably by developing sales for PWT's products within our list of 500 water treatment systems installed over the years.

Our activities in the maple syrup industry, which originate from the very foundation of the company, have also recorded solid results during this year. A growing reputation in the market and new marketing tools, such as web site, catalogs and new sales representatives have enabled this unit to **RECORD STRONG SALES GROWTH**. The manufacturing of systems and products for the maple syrup industry increases the occupancy level of our Ham-Nord plant, thereby maximizing fixed costs. Our maple syrup product line includes membrane filtration systems used for the production of maple syrup as well as related equipment and supplies.

Our 2011 objectives

For fiscal 2011, which we have just begun, our key objectives include **RESUMING GROWTH IN SALES** and bookings, generating positive cash-flows from operating activities, and **INCREASING OUR GROSS MARGIN**. Our hybrid offer, which combines systems and maintenance solutions – a unique case in the industry – will be core to our sales growth strategy for fiscal 2011.

Three factors will help us increase our gross margin for fiscal 2011:

- Maintaining a 70%–30% revenue split, where 70% of our total revenue come from equipment and system sales and 30% from the sale of consumables and services;

- Increasing sales of systems designed for industrial use, to be bolstered by economic recovery, a rebound in capital investment by North American businesses, but mostly by our own **RESEARCH AND DEVELOPMENT PROJECTS**, wherein we develop new applications for our systems and improve system performance in collaboration with some major clients;

- Continuing to implement new **OPTIMIZED PRODUCTION METHODS**, beginning with design (including technical drawings) and extending to the assembly of our systems, as well as in the chemical composition stages of our membrane maintenance and cleaning solutions.

Increasing our international activities to boost growth

The escalation of our international activities, started during fiscal 2010, will continue in 2011. Supported by a well defined action plan, our team dedicated to international operations will continue working hard to secure new contracts in some high-growth regions, such as Northern Africa, the Middle-East, Russia, former Soviet republics, and South America. Through implementing our international action plan, we are looking to diversify our geographical sources of revenues, which are, as of today, concentrated in North America. This geographical diversification of our revenue sources started during fiscal year 2010, where 11% of the revenues originated from other regions than North America, compared to only 1% in fiscal 2009.

By offering sourcing and assembly opportunities at a competitive cost, our joint venture H_2O Innovation India represents a **VALUABLE ASSET** in obtaining international contracts, while improving the gross margins when executing these projects.

Investing in our brand

Just as in fiscal 2010, we will continue to invest in our brand throughout this year. The H_2O Innovation brand is now recognized as a leader in the North American water treatment industry and its international reputation continues to enjoy steady growth. Today, ten years after H_2O Innovation was founded and thanks to our expertise, our knowledge, and know-how, our brand has become a **GROWTH VEHICLE** of its own that generates sales and partnership opportunities. H_2O Innovation is now recognized in the industry for its knowledge and its capacity to develop high-performing solutions aimed at resolving the most complex water treatment situations.

We will work to strive and uphold our motto, "Knowledge to Share®". Building on our long-standing relationships with North American and international engineering firms and EPC (Engineering, Procurement and Construction) groups, we will work to build partnerships with local and regional companies, which are often smaller in size. This will allow us to combine our expertise in water treatment system design with local engineering firms' proximity to regional infrastructure markets, which will serve as an additional growth vehicle for our municipal equipment and system sales.

Seizing the demand for water reuse and wastewater treatment systems

We will continue to pay particular attention to increasing sales of our wastewater treatment and water reuse solutions, for which we are experiencing **STRONG DEMAND** from our target market of small and medium municipalities. Water reuse is the fastest growing market segment of the water treatment industry according to industry publication *Global Water Intelligence*.

During fiscal 2010, we signed our first contract in California for the delivery of a Bio-Brane™ water reuse system for irrigation. This **FLAGSHIP PROJECT** involving our patented technology was commissioned soon after the end of fiscal 2010.

Our joint venture H_2O Innovation India also obtained a significant contract for the delivery of a water reuse system for an industrial client in India. During the 2011 fiscal year, we will be seeking to add new sales representatives for this line of systems in the U.S., but also in Canada and abroad so as to **MAXIMIZE ITS POTENTIAL**.

We will continue to remain on the lookout for acquisition opportunities that would complement our technology portfolio or enable us to strengthen our presence in key regions. We will also pursue **STRATEGIC PARTNERSHIPS** such as those concluded in 2010 in India and with 3M Purification. In the space of a few months, partnerships of this kind can have a catalyzing effect on our sales, help increase our gross margin and grow our global exposure.

Fiscal 2010 called upon the **BEST OF OURSELVES** and required us to build on the best talents of our organization. We have emerged stronger commercially and united around a three-pillar growth strategy that combines internal growth, external growth, and strategic partnerships. We are firm believers in our potential and expect to be in a position to secure an increasing and sustained number of new contracts in fiscal 2011 and beyond.

Even though our sales backlog has only slightly increased during the year, from $13.4 million during the first quarter (excluding the $9.4 million contract cancelled by Petro-Canada) to $14.7 million at the fourth quarter, new contract bookings have positively evolved, from $2.7 million in the first quarter to $6.7 million in the fourth quarter. This evolution is a sign of the industry's gradual economic recovery and shows a good success rate in obtaining contracts through bids and tenders.

Finally, the high increase of the bookings over projects delivered ratio in the third and fourth quarters hints at a probable sales increase for the first quarters of fiscal 2011, assuming that recurring sales remain stable.

In closing, on behalf of the Board of directors and myself, I would like to thank **OUR EMPLOYEES** for their unfailing commitment and hard work, as well as **OUR CLIENTS**, for whom we are proud to design top-quality systems. I would also like to thank **OUR BOARD MEMBERS** for their invaluable contribution, dedication, and sound advice. Last but not least, I would like to thank **OUR SHAREHOLDERS** for believing in us day in and day out for the past ten years.

Frédéric Dugré
President and Chief Executive Officer

MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE FINANCIAL SITUATION

H_2O Innovation's President & Chief Executive Officer and Chief Financial Officer have signed a statement of management's responsibility regarding financial information included in this Annual Report. The statement–which can be found page 24–also explains the roles of the Audit Committee and the Board of Directors in respect of financial information included in the Annual Report. This Management's Discussion and Analysis (MD&A) comments on H_2O Innovation's operating results and financial condition for the years ended June 30, 2010 and 2009. The MD&A should be read in conjunction with the consolidated financial statements for the year ended June 30, 2010 and with the accompanying notes.

Certain statements set forth in this Management's Discussion and Analysis regarding the operations and the activities of H_2O Innovation as well as other communications by the Company to the public that describe more generally management objectives, projections, estimates, expectations or forecasts may constitute forward-looking statements within the meaning of securities legislation. Forward-looking statements concern analysis and other information based on forecast future results and the estimate of amounts that cannot yet be yet determined. Forward-looking statements include the use of the words "expect", "believe", "estimate" and other similar terms as well as those usually used in the future and the conditional, notably regarding certain assumptions as to the success of a venture. Those forward-looking statements involve a number of risks and uncertainties which may result in actual and future results of the Company to be materially different than those indicated. Information about the risk factors to which the Company is exposed is provided in the Annual Information Form dated September 21, 2010 available on SEDAR (www.sedar.com). Unless required to do so pursuant to applicable securities legislation, H_2O Innovation assumes no obligation to update or revise forward-looking statements contained in this Management's Discussion and Analysis or in other communications as a result of new information, future events and other changes.

Unless otherwise indicated, all figures in the present report are expressed in Canadian dollars and come from the financial statements prepared in accordance with Canadian generally accepted accounting principles.

Certain comparative figures have been reclassified to conform to the current period's presentation

RESULTS OF OPERATIONS

Years ended June 30	2010	2009	Change
	$	$	$
Sales	27,727,556	31,215,790	(3,488,234)
Gross margin	7,006,006	7,421,868	(415,862)
Gross margin	25.3%	23.8%	1.5%
Operating, selling administrative and general expenses	9,142,702	6,555,534	2,587,168
Net loss	(9,997,917)	(65,148)	(9,932,769)
Basic and diluted loss per share	(0.181)	(0.001)	(0.180)
EBITDA[1]	(2,821,046)	1,115,441	(3,936,487)
Assets	36,925,752	51,908,092	(14,982,340)
Long-term financial liabilities	2,923,730	5,292,142	(2,368,412)

Results of operations

The 2010 fiscal year was marked by the integration of the operations of the U.S. subsidiary Professional Water Technologies “PWT” (acquired in June 2009). This acquisition transforms our business model by adding recurring revenues in nature and allowing us to better use our customer base, in particular through the offering of value-added products that are necessary to the operation and maintenance of membrane filtration systems of our customers. Besides contributing to revenues, PWT’s acquisition reduces the fluctuation of quarterly revenues and improves gross margin, consumables and services sales, generating a higher gross margin than sales of equipment and systems. In the end, this fiscal year was marked by a significant impairment of intangible assets and goodwill for a net $6.1 M.

Sales and gross margin

Sales decreased by $3.5 M compared to 2009, down by 11 %. The results of this fiscal year were strongly colored by the economic slowdown of the North American economy, which concentrates most of our business. Let’s remind that during the second quarter, the Company announced the cancellation of a contract prior to execution of $9.4 M with Petro-Canada Oil Sands Inc. (“PCOSI", now Suncor) as well as the postponement of some municipal and institutional projects, creating a backlog of approximately $2.5 M in the recognition of revenue for fiscal 2010. These revenues will be recognized during fiscal 2011. However, the growing contribution of revenues from consumables and services, including revenues from the acquisition of PWT, helped to reduce somewhat the decrease in revenue for the year.

This decrease of sales led to a lower nominal value of gross margin, which decreased from $7.4 M in fiscal 2009 to $7.0 M in fiscal 2010. However, there was a significant increase of 1.5% of the gross margin, which rose from 23.8% in fiscal 2009 to 25.3% in fiscal 2010. This increase is due primarily to a higher proportion of revenues from after-sales services and consumables, generating a higher gross margin compared to sales of equipment and systems.

	Fiscal Year 2010			
	Q1	**Q2**	**Q3**	**Q4**
Backlog	$22.8M*	$19.2M*	$14.5M	$14.7M
Orders for equipment and systems	$2.7M	$4.2M	$5.8M	$6.7M
Sales of equipment and systems	$6.1M	$4.7M	$3.6M	$3.1M
Ratio Orders / sales	***0.4***	***0.9***	***1.6***	***2.2***
Sales of services and consumables (usually recurrent)	$2.3M	$2.4M	$2.7M	$2.8M

* Before the cancellation of the $ 9.4 million contract for PCOSI

The backlog, consisting solely of sales of systems and equipment, has increased marginally during the year, from $13.4 M (considering the cancellation of the $9.4 M project for PCOSI) in the first quarter to $14.7 M in the fourth quarter. In return, it is important to note that the signing of new contracts for systems and equipment developed positively during the year, from $2.7 M for the first quarter to $6.7 M in the fourth quarter. This reflects a sign of gradual economic recovery in our industry. Finally, the strong increase in the ratio of new orders on sales projects in the third and fourth quarters suggests a likely increase in turnover for the first quarters of fiscal 2011, assuming sales recurring in nature remain stable.

Operating expenses

Operating, selling, administrative and general expenses increased $2.6 M in fiscal 2010 compared to fiscal 2009. The nominal increase can be attributed to the integration of PWT, which is around $1.4 M. The sale of services and consumables requires a more important customer support than the sale of systems and equipment, resulting in a higher percentage of our cost of sales and administration. This effect is offset by the higher gross margin generated by recurring sales of these products and services.

The increase in the depreciation of intangible assets in 2010 compared to 2009 can mainly be attributed to PWT's acquisition.

For the fiscal year ended June 30, 2010, the stock-based compensation decreased to $0.08 M from $0.3 M in the 2009 fiscal year. This nominal decrease of $0.25 M can mainly due to the decrease in stock option grants in fiscal 2009 and 2010. During fiscal 2010, following the non-achievement of financial targets set earlier this year, senior executives of the Company have waived payment of premium performance.

In the third quarter of fiscal 2010, the Company performed its annual impairment test for goodwill. Recoverability of goodwill is determined at the Company's single reporting unit level, using a two-step approach. First, the carrying value of the reporting unit is compared to its fair value. If the net carrying value of the reporting unit exceeds its fair value, the second step is performed to determine the amount of the impairment loss. Following the decrease in the Company's stock price in June 2010, we came to the conclusion that the net carrying value of our reporting unit exceeded its fair value for fiscal 2010, and recorded an impairment charge of $4.9 M in fiscal 2010, to bring the goodwill to its fair value. The fair value of the reporting unit was determined based on a combination of market capitalization and discounted cash flows. Discounted cash flows were estimated over periods varying from five to ten years and based on a discount rate of 14.25%.

Using the same test for annual impairment, the recoverability of intangible assets has also been tested. The Company recorded an impairment of $1.8 M during fiscal 2010, to present intangible assets at fair value.

These impairments have generated a recovery of future income tax of $0.6 M. This charge had no monetary impact on fiscal 2010's results.

1- Earnings before interests, taxes, depreciation and amortization (EBITDA) is a performance indicator that is not determined in accordance with Canadian generally accepted accounting principles and is not intended as an alternative measure of net earnings. Because EBITDA may not be calculated identically by all companies, the Company's result may not be directly comparable to similarly titled measures of other companies.

EBITDA

Years ended June 30	2010	2009
	$	$
Loss before income taxes	(12,166,440)	(797,259)
Depreciation of fixed assets	290,484	273,687
Amortization of intangible assets	1,391,338	1,192,259
Bank charges and other financial expenses	135,677	62,879
Interest on long-term debt	848,034	383,875
Impairment of intangibles assets	1,763,861	-
Impairment of goodwill	4,916,000	-
EBITDA[1]	(2,821,046)	1,115,441

EBITDA[1] for fiscal year 2010 was ($2.8 M), compared to $1.1 M for fiscal 2009. The decrease in EBITDA[1] in 2010 is due to a loss on exchange rate of ($0.6 M) in 2010 compared to a gain on exchange rate of $0.4 M in 2009, with a total gap of $1.0 M, and to a decrease in sales of 11% mainly caused by the postponement of two projects totalling $2.5 M, the cancellation of the $9.4 M project for PCOSI, a slowing U.S. economy and rising operating, sales, administrative and overhead costs caused by PWT's acquisition, in particular. By implementing a cost reduction and spending control program shortly following the end of the third quarter, the Company aims at achieving positive EBITDA as quickly as possible without compromising its growth opportunities. Despite these cost reductions, the Company has kept its key personnel and know-how, which are essential to its sustainability and organic growth.

Other incomes and expenses

The significant foreign exchange gain variation of $0.4 M as at June 30, 2009, compared to a loss on exchange rate of ($0.6 M) as at June 30, 2010, is mainly attributable to the impact of the weakening of the U.S. dollar against the Canadian dollar on the Company's assets and liabilities in U.S. dollars. This loss on exchange rate is primarily unrealized as at 30 June 2010 and relates to the translation of assets and liabilities in U.S. dollars and results of the Company's U.S. operating subsidiaries. This change had no monetary impact on the Company.

The interest expense on long-term debt, totalling $0.8 M as at June 30, 2010, is mainly related to the convertible debenture and the new long-term debts incurred during the previous year. Of this amount, $0.26 M represents the theoretical and non-monetary part of interest on the convertible debenture and long-term debts.

During the year, the Company completed a non-recurring loss of $0.1 M following the disposal of an unused section of the building held in Ham-Nord and the cancellation of value attached to a patent on technology that was no more commercialized and that the Company has divested. This charge had no monetary impact on fiscal 2010's results.

Costs related to acquisitions and integrations were down compared to 2009, from $0.1 M as at June 30, 2009 to $0.03 M as at June 30, 2010.

Net loss

The net loss experienced a significant increase compared to 2009 from $0.1 M ($0.001 per share) for the year ending June 30, 2009 to $10 M ($0.181 per share) for the one ending June 30, 2010. This nominal increase is explained by the impairment of intangible assets of $1.8 M, impairment of goodwill of $4.9 M, the change in exchange rates over the previous year of $1.0 M as well as the decrease in products by 11% compared to last year.

For the year ended June 30, 2010, the Company recognized $2.2 M as future income taxes related to variations in future tax liabilities accounted for in the acquisitions of Itasca Systems Inc. and Wastewater Technologies Inc. as well as future taxes relating to losses not deducted in the United States.

Fourth quarter (unaudited)

	Fourth quarter ended June 30	
	2010	2009
Sales	**5,921,355**	7,322,452
Cost of goods sold	**4,595,990**	6,016,247
Gross margin	**1,325,365**	1,306,205
Gross margin	**22.4%**	17.8%
Net loss	**(6,220,440)**	(1,067,448)
Basic and diluted loss per share	**(0.113)**	(0.022)
EBITDA[1]	**(785,178)**	(1,301,901)

Sales for the 2010 fourth quarter decreased by 19 % compared to the corresponding quarter of the previous fiscal year. However, despite this decline in sales, gross margin has improved significantly during the fourth quarter, from 17.8% for the 2009 fourth quarter to 22.4% for the same quarter in 2010. This increase is due primarily to a higher proportion of revenues from sales of services and consumables, generating a higher gross margin compared to the sale of equipment and systems. This fourth quarter generated a loss of $6.2 M compared to a loss of $1.1 M in the same quarter in 2009. This can mainly be explained by impairment of intangible assets and goodwill for respectively $1.8 M and $4.9 M.

Quarterly Summary Financial Information (unaudited)

	Fiscal Year 2010				
	Q1	**Q2**	**Q3**	**Q4**	**June 30**
Sales	$8.4M	$7.1M	$6.3M	$5.9M	$27.7M
Gross margin	29.8%	22.1%	25.4%	22.4%	25.3%
Net loss	($0.6M)	($1.6M)	($1.6M)	($6.2M)	($10M)
Basic and diluted loss per share	(0.012)	(0.029)	(0.028)	(0.113)	(0.181)

	Fiscal Year 2009				
	Q1	**Q2**	**Q3**	**Q4**	**June 30**
Sales	$5.6M	$9.5M	$8.8M	$7.3M	$31.2M
Gross margin	24.4%	25.6%	26.4%	17.8%	23.8%
Net profit (loss)	($0.4M)	$0.7M	$0.7M	($1.1M)	($0.1M)
Basic and diluted profit (loss) per share	(0.009)	0.015	0.014	(0.022)	(0.001)

Commitments

The Company has entered into long-term lease agreements expiring in 2010, 2012, 2013 and 2017 which call for lease payments of $2,044,070 for the rental of space. The minimum annual lease payments over the next five years are $484,300 in 2011, $412,400 in 2012, $352,600 in 2013 and $191,600 in 2014 and $196,200 in 2015.

Information on share capital

As at September 21, 2010, the Company had 60,120,832 outstanding shares, 1,970,000 stock options and 9,179,877 warrants. The increase in outstanding shares between June 30, 2009 and September 21, 2010 is attributable to the issuance of 4,955,884 common shares in connection with a private financing and to the exercise of stock options for 25 000 shares issued. In the case of conversion of the debenture, there would be 1,435,407 shares.

During the year the Company granted to its directors a total of 205,000 stock options with an exercise price of $0.75 in accordance with the terms and conditions of its stock option plan.

FINANCIAL SITUATION

Before the change in operating working capital, **operating activities** used \$3.4 M in cash for the fiscal year 2010, compared to \$1.1 M of cash generated during the corresponding period ended June 30, 2009. The increase in funds used by operating activities is attributable to the increase in net loss caused by the loss on exchange rate mostly unrealized as at June 30, 2010 and to declining sales over the previous year, as explained above under "Sales and gross margin". The implementation of the cost reduction and spending control program should help mitigating this impact in the next quarters.

Investing activities generated net cash of \$0.3 M. The Company made acquisitions of tangible and intangible assets, of which \$0.27 M are not recurring. In addition, there was disposal of investments held for trading during the year. These investments mainly focused on buying a new computer server and leasehold improvements of facilities in Vista, California.

Financing activities required cash of \$0.77 M. In June 2010, the Company has fully repaid the loan from a Canadian chartered bank and has completed equity financing from various investors for \$2.1 M.

CAPITAL MANAGEMENT

The Company's objective when managing capital is to maintain a flexible capital structure, which optimizes the cost of capital at an acceptable risk level. For capital management purposes, the Company defines its capital as follows : shareholders' equity, long-term debt, convertible debenture less cash and cash equivalents, held-for-trading investments and held-to-maturity investment. The Company monitors capital in light of its monthly needs and obligations linked to its financial liabilities.

The bank loan includes certain covenants regarding among others, the working capital, the debt coverage ratio and the debt ratio. Management is conducting a thorough follow-up of these ratios, which are all respected as at June 30, 2010. Except for covenants relating to the bank loan, the Company is not subject to any other capital requirement imposed by a third party.

ACCOUNTING ESTIMATES AND DEVELOPMENTS CONCERNING ACCOUNTING POLICIES

Accounting Estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the amounts recorded in the financial statements and notes to financial statements. These estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future. Actual results may differ from these estimates.

The most significant estimates include, but are not limited to, assumptions used for testing for impairment of goodwill and long-lived assets, the estimated useful lives of depreciable long-lived assets, the recoverability of tax credits and allowances for doubtful accounts, inventory obsolescence and valuation allowances against future income tax assets.

Changes in accounting policies in effect

On July 1, 2009, the Company adopted Section 3064, "Goodwill and Intangible Assets" of the Canadian Institute of Chartered Accountants ("CICA") Handbook. This section establishes standards for the recognition, measurement, and disclosure of goodwill and intangible assets. This section replaces Section 3062, "Goodwill and Other Intangible Assets" and Section 3450,"Research and Development Costs". The adoption of this section had no impact on the Company's consolidated financial statements and results of operations.

Future accounting changes

The CICA published the following sections of the CICA Handbook that apply to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011 :

a) Section 1582, “Business Combinations”, which replaces the former Section 1581 with the same title, establishes standards for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS 3, “Business Combinations”.

b) Section 1601, “Consolidated Financial Statements”, which replaces the former Section 1600 with the same title, establishes standards for the preparation of consolidated financial statements.

c) Section 1602, “Non-Controlling Interests”. This new section establishes standards on accounting for non-controlling interests in a subsidiary in consolidated financial statements prepared subsequent to a business combination. It is equivalent to the corresponding provisions of International Accounting Standard IAS 27, “Consolidated and Separate Financial Statements”.

The Company is presently evaluating the impact of these new standards on its financial statements.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

In February 2008, the Accounting Standards Board (“AcSB”) confirmed that Canadian GAAP for publicly accountable enterprises will be converged with IFRS, effective in calendar year 2011, with early adoption allowed starting in calendar year 2009. For the Company, the changeover to IFRS will be required for interim and annual financial statements beginning on July 1, 2011. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences on recognition, measurement, presentation and disclosures.

An implementation plan for the IFRS adoption strategy is being developed. The activities planned include the identification and documentation of existing differences between IFRS and Canadian GAAP in accounting and disclosure requirements; the selection of IFRS accounting policies, including the consideration of options available under IFRS; the determination of the impact of conversion on internal controls, accounting systems and other business solutions and processes; and the development of a training program to assist appropriate employees in the transition to and the ongoing compliance with IFRS.

The Company has decided to switch to IFRS on July 1, 2011. Some options permitted under IFRS are currently under analysis. The various activities related to the IFRS implementation plan will continue throughout the year 2010.

OFF-BALANCE SHEET ARRANGEMENTS

As at June 30, 2010, the Company had off-balance sheet arrangements consisting of letters of credit amounting to $1,26 M; these letters of credit expire at various dates through fiscal 2012. In these letters of credit, $1 M are secured by a deposit certificate. The balance, amounting to $0.26 M, was guaranteed by *Export Development Canada*.

FINANCIAL RISK MANAGEMENT AND FINANCIAL RISKS

The Company is exposed to various financial risks resulting both from its operations and its investment activities. The Company's Management manages financial risks.

Financial risks

The Company's main financial risk exposure and its financial risk management policies are as follows.

The following risk factors relating to the Corporation are not all inclusive; the Corporation operates in a constant changing sector which can cause new risk factors to arise. The Corporation is not in position to neither predict these risk factors, nor evaluate their impact, as the case may be, on its activities, nor to evaluate to what extent may a factor, or a combination of factors, cause actual results to differ from those presented in the forward-looking statements. Therefore, the Corporation does not rely on and the Corporation's shareholders should not rely on the forward-looking statements as a pledge of actual results.

Fair value

Amendments to 3862, "Financial Instruments – Disclosures", establish a fair value hierarchy which requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company primarily applies the market approach for recurring fair value measurements. The Section describes three input levels that may be used to measure fair value:

Level 1
Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2
Inputs other than quoted prices included in 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
Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Financial instruments whose carrying value approximates fair value

Cash and cash equivalents, held-for-trading investments, held-to-maturity investment, accounts receivable and accounts payable and accrued liabilities are financial instruments whose fair value approximates their carrying value due to their short-term maturity. The input level used by the Company to measure fair value of its cash and cash equivalents, held-for-trading investments and held-to-maturity investment is a Level 1 because they are valued using quoted market prices.

Long-term debt and convertible debenture

The fair value of the long-term debt and the convertible debenture has been established by discounting the future cash flows at an interest rate to which the Company would currently be able to obtain for loans with similar maturity dates and terms. The fair value of the long-term debt is $ 2,188,968 ($4,928,535 as at June 30, 2009) and the fair value of the convertible debenture is $1,354,530 ($1,238,607 as at June 30, 2009).

Credit risk

Credit risk relates to the risk that a party to a financial instrument will not fulfil some or all of its obligations, thereby causing the Company to sustain a financial loss. The main risk relates to accounts receivable. To manage credit risk from accounts receivable, the Company records allowances, determined on a client-per-client basis, at the balance sheet date to account for potential losses.

The carrying amount on the balance sheet of the Company's financial assets exposed to credit risk represents the maximum amount exposed to credit risk.

The Company is also exposed to credit risk due to cash, its deposit certificate and investments certificates. The Company has $3,979,034 ($7,659,553 in 2009) in cash and investments with banking institutions that the Company considers at a low risk for loss.

Exchange risk

The Company is exposed to exchange risk as a result of its U.S. dollar purchases and sales and also as a result of its foreign subsidiary net assets. To limit the impact of fluctuations of the Canadian dollar over the U.S. dollar, the Company matches, in general and when possible, the cash receipts in a foreign currency with the cash disbursements in the same foreign currency. The Company does not use derivative financial instruments to cover the variability of cash flows in foreign currencies.

As at June 30, 2010, if the Canadian dollar had increased or decreased by five (5) cents compared to the U.S. dollar, assuming that all other variables remained constant, net loss for the year ended June 30, 2010 would have been greater or lesser by approximately $80,000 ($116,600 as at June 30, 2009).

The financial assets and liabilities denominated in U.S. dollars are as follows:

AS AT JUNE 30	**2010**	2009
	US$	US$
FINANCIAL ASSETS		
CASH	**1,849,703**	1,633,211
INVESTMENTS	**52,922**	53,276
ACCOUNTS RECEIVABLE	**3,149,411**	7,291,369
	5,052,036	8,977,856
FINANCIAL LIABILITIES		
ACCOUNTS PAYABLE	**3,180,522**	4,244,179
LONG-TERM DEBT	**450,000**	450,000
	3,630,522	4,694,179

Interest rate risk

In the normal course of business, the Company is exposed to interest rate fluctuation risk as a result of the floating-rate loans and debts receivable and loans payable. The Company manages its interest rate fluctuation exposure by allocating its financial debt between fixed and floating-rate instruments.

The deposit certificates, investment certificates, investments, unsecured loans and the convertible debenture bear interest at fixed rates and the Company is, therefore, exposed to the risk of changes in fair value resulting from interest rate fluctuations.

The bank loans bear interest at floating rates and the Company is, therefore, exposed to the cash flow risks resulting from interest rate fluctuations.

Liquidity risk

Liquidity risk is the risk that the Company will be unable to fulfil its obligations on a timely basis or at reasonable cost. The Company manages its liquidity risk by monitoring its operating requirements and using various funding sources to ensure its financial flexibility. The Company prepares budgets and cash forecasts to ensure that it have sufficient funds to fulfil its obligations.

For its investing activities, the Company will evaluate its liquidity needs when applicable and take the necessary action.

Competitive environment

In the markets served by the Corporation, competition is based on a number of factors, especially price, technology, application know-how, financing viability, corporate image, product warranty, reliability, distribution network and after-sale service. Some competitors of the Corporation have the benefit of relying on larger resources, notably financial, than the Corporation’s resources.

Management and employees

The Corporation relies heavily on its ability to attract and retain highly skilled personnel in a competitive environment.

The Corporation may be unable to recruit, retain, and motivate highly skilled employees in order to assist in the Corporation's business, especially sales activities that are essential to the success of the Corporation. Failure to recruit and retain highly-skilled employees may adversely affect the Corporation's business, financial condition and results of operations. To counterbalance this risk, the Corporation deploys energy and efforts on the transfer of knowledge between its human resources. These efforts are part of a structured program called "knowledge to share".

Implementation of a commercial strategic plan

The commercial strategy of the Corporation includes taking decisions to increase research and development expenses, concluding strategic acquisitions of products and technologies and introducing new products and services. The strategic plan of the Corporation should be considered under risks perspective, expenses and difficulties frequently encountered by a developing business. The successful viability of the Corporation's growth strategy may require capital investments larger than those previously expected and nothing warrants that the Corporation will reach the desired growth level.

Fixed Price Contracts

The Corporation enters into fixed price manufacturing contracts based upon estimates of technical risks and total production costs. Such estimates, if materially inaccurate, can result in potential losses related to fulfilling the contractual obligations of the Corporation.

Product Liability

The Corporation is subject to potential product liabilities connected with its operations, including liabilities and expenses associated with product defects. These operations of the Corporation have product liability and other insurance coverage that management of the Corporation believes is generally in accordance with the market practice in its industry.

Technology and regulatory changes

The water treatment industry is characterized by evolving technologies, competition imposed standards and regulatory requirements which have an impact on the demand and compel the Corporation to improve its products and services. The evolution of legal, regulatory or local requirements may render obsolete some products and some water treatment processes offered by the Corporation. The acceptance of new products may also be negatively impacted by the enforcement of new governmental legislation imposing more stringent standards.

The Corporation is also subject to risks associated with the introduction of new products and applications, especially the non-acceptance on the markets, a delay in the development or a malfunction of the products.

Market Liquidity

There is currently limited active trading in the Corporation's common shares, which could result in a lack of liquidity for those shares. The market price for the common shares of the Corporation could consequently be subject to wide fluctuations. Factors such as the announcement of the signature of important contracts, technological innovations, new commercial products, patents, a change in regulations, quarterly financial results, future sales of common shares by the Corporation or current shareholders, and many other factors could have considerable repercussions on the price of the Corporation's common shares. In addition, the financial markets may experience significant price and value fluctuations that affect the market prices of equity securities of companies that sometimes are unrelated to the operating performance of these companies. Broad market fluctuations, as well as economic conditions generally may adversely affect the market price of the Corporation's common shares.

Acquisition and Expansion Risk

The Corporation may expand its operations, depending on certain conditions, by acquiring additional businesses, products or technologies. There can be no assurance that the Corporation will be able to identify, acquire or profitably manage additional businesses, or successfully integrate any acquired business, products, or technologies into the business without substantial expenses, delays or other operational or financial difficulties. There can be no assurance that acquired businesses, products or technologies, if any, will achieve anticipated revenues and income.

Capital investment

The business of the Corporation depends in part upon capital purchasing by its customers. In many cases such capital expenditures are substantial in relation to the customer's operating budget. The technologies of the Corporation frequently represent a new solution to the customer's water treatment problems, leading to a need to educate the customer. As a result, a significant proportion of the Corporation's business is made up of orders that are large in relation to total revenue and subject to selling periods which may exceed one year as well as to deferment and cancellation.

Additional financing and dilution

The Corporation does not exclude raising additional funds by equity financing. Also, 9,179,877 warrants and 1,950,000 share purchase options are currently issued and outstanding.

The exercise of warrants and share purchase options, as well as the possibility of new equity financings, represent dilution factors for present and future shareholders.

Current Global Financial Conditions

Current challenging global financial conditions have been characterized by increased volatility and numerous financial institutions have gone into bankruptcy or have had to be rescued by governmental authorities. This has contributed to a reduction in liquidity among financial institutions and has reduced the availability of credit to those institutions and to the issuers who borrow from them. These factors may impact the ability of the Corporation to obtain equity or debt financing on terms favourable to the Corporation. As such, continued increased levels of volatility and market turmoil may impact the Corporation's operations and adversely affect the price of the common shares of the Corporation.

Development of New Products

From time to time, the Corporation develops new products of a specialized nature that have inherent risks. The major risks include:

(a) technical risk that either the product does not perform as desired or unacceptable reliability issues render the new product un-merchantable; and

(b) supplier risk that required components procured from third party vendors, do not perform in an acceptable manner, thereby having an adverse impact on marketability of such new products and the Corporation's product liability.

SUBSEQUENT EVENT

Modification of the repayment terms of the convertible debenture

In July 2010, the convertible debenture repayment terms, which initially stipulated one $1,500,000 installment payable on July 9, 2011, were modified as follows: six $250,000 installment payable every three months from July 9, 2011 to October 9, 2012. The applicable annual interest rate of 10% was increased by 1% to reach 11% as from July 9, 2010. The other debenture terms remain unchanged.

CONTROLS AND PROCEDURES

In compliance with the Canadian Securities Administrators' National Instrument 52-109 ("NI 52-109"), we have filed certificates signed by the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") that, among other things, report on the design and effectiveness of disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting.

Disclosure controls and procedures

The CEO and the CFO have designed disclosure controls and procedures, or have caused them to be designed under their supervision, in order to provide reasonable assurance that:

- material information relating to the Corporation has been made known to them; and
- information required to be disclosed in the Corporation's filings is recorded, processed, summarized and reported within the time periods specified in securities legislation.

An evaluation was carried out, under the supervision of the CEO and the CFO, of the effectiveness of our disclosure controls and procedures. Based on this evaluation, the CEO and the CFO concluded that the disclosure controls and procedures are effective.

Internal controls over financial reporting

The CEO and the CFO have also designed internal controls over financial reporting, or have caused them to be designed under their supervision, in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP.

An evaluation was carried out, under the supervision of the CEO and the CFO, of the design and effectiveness of our internal controls over financial reporting. Based on this evaluation, the CEO and the CFO concluded that the internal controls over financial reporting are effective, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) on Internal Control – Integrated Framework.

Changes in internal controls over financial reporting

No changes were made to our internal controls over financial reporting that occurred during the fourth quarter of fiscal year 2010 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The Consolidated Financial Statements and Management's Discussion and Analysis ("MD&A") of H_2O Innovation Inc. and all other information in this Annual Report are the responsibility of Management and have been reviewed and approved by the Board of Directors.

The Consolidated Financial Statements have been prepared by Management in accordance with Canadian generally accepted accounting principles. The MD&A has been prepared in accordance with the requirements of securities regulators. The financial statements and MD&A include items that are based on best estimates and judgments of the expected effects of current events and transactions. Management has determined such items on a reasonable basis in order to ensure that the financial statements and MD&A are presented fairly in all material respects. Financial information presented elsewhere in the Annual Report is consistent with that in the Consolidated Financial Statements.

H_2O Innovation's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") have designed disclosure controls and procedures, or have caused them to be designed under their supervision, to provide reasonable assurance that material information relating to H_2O Innovation Inc. has been made known to them; and information required to be disclosed in H_2O Innovation Inc.'s filings is recorded, processed, summarized and reported within the time periods specified in securities legislation.

H_2O Innovation's CEO and CFO have also evaluated the effectiveness of H_2O Innovation's disclosure controls and procedures as of the end of fiscal year 2010. Based on this evaluation, the CEO and the CFO concluded that the disclosure controls and procedures were effective as of that date, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) on Internal Control – Integrated Framework. In addition, based on this assessment, they determined that there were no material weaknesses in internal control over financial reporting as of fiscal year 2010. In compliance with NI 52-109, H_2O Innovation's CEO and CFO have provided a certification related to H_2O Innovation's annual disclosure to the Canadian Securities Administrators, including the Consolidated Financial Statements and MD&A.

The Board of Directors is responsible for ensuring that Management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the Consolidated Financial Statements and MD&A. The Board of Directors carries out this responsibility principally through its Audit Committee.

The Audit Committee is appointed by the Board of Directors and is comprised entirely of independent and financially literate directors. The Audit Committee meets periodically with Management, as well as with the internal and external auditors, to review the Consolidated Financial Statements, external auditors' report, MD&A, auditing matters and financial reporting issues, to discuss internal controls over the financial reporting process, and to satisfy itself that each party is properly discharging its responsibilities. In addition, the Audit Committee has the duty to review the appropriateness of the accounting policies and significant estimates and judgments underlying the Consolidated Financial Statements as presented by Management, and to review and make recommendations to the Board of Directors with respect to the fees of the external auditors. The Audit Committee reports its findings to the Board of Directors for its consideration when it approves the Consolidated Financial Statements and MD&A for issuance to shareholders.

The Consolidated Financial Statements have been audited by PricewaterhouseCoopers LLP, the external auditors, in accordance with Canadian generally accepted auditing standards on behalf of the shareholders. The external auditors have full and free access to the Audit Committee to discuss their audit and related matters.

Frédéric Dugré
President and Chief Executive Officer

Annie Lemieux, CA
Chief Financial Officer

September 21, 2010

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l.Chartered Accountants
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Auditors' Report

To the Shareholders of
H_2O Innovation Inc.

We have audited the consolidated balance sheet of **H_2O Innovation Inc.** as at June 30, 2010 and the consolidated statements of earnings and comprehensive loss and deficit and cash flows for the year then ended. These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at June 30, 2010 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements of the company as at June 30, 2009 and for the year ended June 30, 2009 have been audited by Raymond Chabot Grant Thornton LLP whose report dated September 3, 2009 expressed an unqualified opinion on those financial statements.

PricewaterhouseCoopers LLP[1]

Québec, Quebec, Canada
September 21, 2010

[1] Chartered accountant auditor permit No. 11070

(1)

H_2O INNOVATION INC.

CONSOLIDATED BALANCE SHEETS

As at June 30	**2010**	2009
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	**2,672,375**	5,594,406
Held-for-trading investments (note 5)	**1,266,751**	2,021,070
Held-to-maturity investment (note 6)	**39,908**	-
Accounts receivable (note 7)	**4,857,285**	10,223,766
Inventories (note 8)	**1,915,107**	1,784,938
Work in process	**2,148,946**	1,023,259
Prepaid expenses	**308,263**	258,271
Future income tax assets (note 17)	**-**	375,376
	13,208,635	21,281,086
Held-to-maturity investment (note 6)	**-**	44,077
Fixed assets (note 9)	**2,451,115**	2,469,680
Intangible assets (note 10)	**10,313,821**	13,445,145
Other assets	**44,141**	51,890
Goodwill (notes 3 and 11)	**10,901,443**	14,616,214
Future income tax assets (note 17)	**6,597**	-
	36,925,752	51,908,092
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities (note 13)	**4,815,253**	5,648,683
Billings in excess of work in process	**233,537**	1,346,038
Current portion of long-term debt (note 14)	**619,768**	875,000
	5,668,558	7,869,721
Long-term debt (note 14)	**1,569,200**	4,053,535
Convertible debenture (note 15)	**1,354,530**	1,238,607
Deferred rents	**56,938**	76,969
Future income tax liabilities (note 17)	**-**	2,552,634
	8,649,226	15,791,466
SHAREHOLDERS' EQUITY		
Equity component of convertible debenture (note 15)	**301,023**	301,023
Capital stock (note 16)	**45,858,645**	43,778,820
Contributed surplus	**11,453,475**	11,375,483
Deficit	**(29,336,617)**	(19,338,700)
	28,276,526	36,116,626
	36,925,752	51,908,092

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

On behalf of the Board,

Frédéric Dugré
President and Chief Executive Officer

Philippe Gervais
Chairman of the Board of Directors

CONSOLIDATED STATEMENT OF EARNINGS AND COMPREHENSIVE LOSS

Years ended June 30	2010	2009
	$	$
Sales	**27,727,556**	31,215,790
Cost of goods sold (note 19)	**20,721,550**	23,793,922
Gross margin	**7,006,006**	7,421,868
Expenses		
Operating, selling, administrative and general expenses	**9,142,702**	6,555,534
Depreciation of fixed assets	**290,484**	273,687
Amortization of intangible assets	**1,391,338**	1,192,259
Impairment of intangible assets	**1,763,861**	-
Impairment of goodwill	**4,916,000**	-
Bank charges and other financial expenses	**135,677**	62,879
Government assistance	**(129,411)**	(153,527)
Stock-based compensation	**82,992**	333,662
	17,593,643	8,264,494
Operating loss before the following items	**(10,587,637)**	(842,626)
Investment income	**6,405**	44,008
Rental and interest income	**24,616**	49,951
Other income	**11,075**	10,252
Exchange gain (loss)	**(608,908)**	429,098
Interest on long-term debt	**(848,034)**	(383,875)
Loss on disposal of fixed assets	**(120,964)**	-
Loss on disposal of intangible assets	**(15,955)**	-
Acquisition and integration expenses	**(27,038)**	(104,067)
	(1,578,803)	45,367
Loss before income taxes	**(12,166,440)**	(797,259)
Income tax expense (recovery)		
Current	**15,332**	64,635
Future	**(2,183,855)**	(796,746)
	(2,168,523)	(732,111)
Net loss and comprehensive loss for the year	**(9,997,917)**	(65,148)
Basic and diluted net loss per share	**(0.181)**	(0.001)
Weighted average number of shares outstanding (note 20)	**55,160,147**	47,722,705

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

CONSOLIDATED STATEMENT OF CONTRIBUTED SURPLUS AND DEFICIT

Years ended June 30	**2010**	2009
	$	$
Contributed surplus		
Opening balance	**11,375,483**	9,619,819
Stock-based compensation	**82,992**	333,662
Exercise of stock options	**(5,000)**	-
Warrants issued in connection with long-term debt	**-**	229,454
Warrants issued in connection with private placements	**-**	1,192,548
Closing balance	**11,453,475**	11,375,483
Deficit		
Balance - Beginning of year	**(19,338,700)**	(19,273,552)
Net loss for the year	**(9,997,917)**	(65,148)
Balance - End of year	**(29,336,617)**	(19,338,700)

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

CONSOLIDATED STATEMENT OF CASH FLOWS

Years ended June 30	2010	2009
	$	$
Cash flows from operating activities		
Net loss	**(9,997,917)**	(65,148)
Non-cash items		
Change in fair value of held-for-trading investments	**4,319**	9,737
Interest capitalized on held-to-maturity investment	**(455)**	(1,308)
Exchange (gain) loss on held-to-maturity investment	**3,740**	(5,791)
Depreciation of fixed assets	**290,484**	273,687
Amortization of intangible assets	**1,391,338**	1,192,259
Loss on disposal of fixed assets	**120,964**	-
Loss on disposal of intangible assets	**15,955**	-
Stock-based compensation	**82,992**	333,662
Future income taxes	**(2,183,855)**	(796,746)
Unrealized exchange gain on long-term debt	**(36,824)**	-
Imputed interest on long-term debt and convertible debenture	**256,930**	110,534
Impairment of intangible assets	**1,763,861**	-
Impairment of goodwill	**4,916,000**	-
	(3,372,468)	1,050,886
Change in working capital items (note 21)	**881,799**	(1,279,814)
	(2,490,669)	(228,928)
Cash flows from investing activities		
Disposal of held-for-trading investments	**750,884**	300,000
Receipts related to the sales-type lease	**-**	70,709
Acquisition of fixed assets	**(513,385)**	(341,846)
Acquisition of intangible assets	**(84,830)**	(112,077)
Proceeds from disposal of fixed assets	**132,145**	-
Proceeds from disposal of intangible assets	**45,000**	-
Business acquisitions (notes 3 and 21)	**-**	(14,093,206)
Other assets	**7,749**	(4,670)
	337,563	(14,181,090)
Cash flows from financing activities		
Repayment of bank loan	**-**	(27,259)
Repayment of notes payable	**-**	(156,157)
Long-term debt reimbursement	**(2,843,750)**	(656,250)
Long-term debt contracted	**-**	5,796,999
Convertible debenture contracted	**-**	1,446,337
Issuance of shares	**2,114,250**	4,275,000
Share issue expenses	**(39,425)**	(223,944)
	(768,925)	10,454,726
Net change in cash	**(2,922,031)**	(3,955,292)
Cash and cash equivalents - Beginning of year	**5,594,406**	9,549,698
Cash and cash equivalents - End of year	**2,672,375**	5,594,406

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Governing Statutes and Nature of Operations

The Company is incorporated under the *Canada Business Corporations Act*. The Company's mission is to design, develop and market innovative environmentally-friendly water treatment technology and to produce high performance products in the field of membrane filtration and biological and physical water treatment solutions. At the same time and on a smaller scale, the Company continues its manufacturing and equipment distribution operations for the maple industry.

2. Summary of Significant Accounting Policies

Basis of presentation

The financial statements are prepared in accordance with Canadian generally accepted accounting principles. The significant accounting policies, which have been applied on a consistent basis, are summarized as follows:

Principles of consolidation

The consolidated financial statements of the Company include the accounts of the Company and its subsidiaries. Intercompany transactions and related balances have been eliminated.

The interest in the joint venture is accounted for using the proportionate consolidation method whereby the Company records its share in the joint venture's assets, liabilities, revenues, expenses and cash flows.

Accounting Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts of assets and liabilities reported in the financial statements. Those estimates and assumptions also affect the disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the years. The most significant estimates include, but are not limited to, assumptions used for testing for impairment of goodwill and long-lived assets, the estimated useful lives of depreciable long-lived assets, the recoverability of tax credits and allowances for doubtful accounts, inventory obsolescence and valuation allowances against future income tax assets. Actual results could differ from those estimates.

Foreign currency translation

Monetary assets and liabilities of Canadian corporations and integrated foreign operations denominated in foreign currencies are translated at the exchange rate in effect at the balance sheet date, whereas other assets and liabilities are translated at the exchange rate in effect at the transaction date. Revenues and expenses are translated at the average exchange rate in effect during the year, with the exception of revenues and expenses relating to non-monetary assets and liabilities, which are translated at historical rate. A exchange gains and losses are reflected in earnings.

Financial assets and liabilities

On initial recognition, all financial assets and liabilities are measured and recognized at their fair value and their subsequent measurement depends on their classification as described below:

Classification

- Held-for-trading financial assets

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Held-for-trading financial assets are measured at their fair value and changes in fair value are recognized in earnings. Held-for-trading financial assets are composed of cash and cash equivalents and held-for-trading investments.

- Held-to-maturity investments, loans and receivables and other financial liabilities

Held-to-maturity investments, loans and receivables and other financial liabilities are measured at amortized cost using the effective interest method. Loans and receivables are composed of accounts receivable and the other financial liabilities are composed of accounts payable and accrued liabilities, long-term debt and convertible debenture.

Transaction costs from held-for-trading financial assets and liabilities are recognized in earnings as incurred. Transaction costs are recognized at the cost of financial assets and liabilities that are not classified as held for trading.

Cash and cash equivalents

Cash includes cash and demand deposits. Cash equivalents include very liquid investments convertible into a known cash amount and maturing within less than three months from the date of acquisition. As at June 30, 2010, the cash equivalents balance is nil (nil as at June 30, 2009).

Inventories

Inventories are valued at the lower of cost and net realizable value. Cost is determined using the first in first out method for raw materials and using the absorption costing method for finished goods.

Fixed assets and depreciation

Fixed assets are recorded at cost and are depreciated over their estimated useful lives using the declining balance method at the following annual rates:

Buildings	4%
Machinery and equipment	20%
Computer equipment	20%
Furniture, fixtures and office equipment	20%
Automotive equipment	30%

Leasehold improvements are depreciated using the straight-line method over the remaining lease term.

Intangible assets

Intangible assets are recorded at cost and amortized over their estimated useful lives using the following amortization methods:

Software is amortized using the declining balance method at an annual rate of 20%.

Rights on technologies and technologies are amortized using the straight-line method over periods of seven (7) and fifteen (15) years.

Patents, trademarks and intellectual property are amortized using the straight-line method over periods of fifteen (15), eighteen (18) and twenty (20) years.

Customer relations are amortized using the straight-line method over periods of five (5) and fifteen (15) years.

Distribution network is amortized using the straight-line method over a period of five (5) years.

Other assets

Other assets are mainly composed of security deposits and are recorded at cost.

Goodwill

Goodwill is the excess of the cost of an acquired enterprise over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired. Any impairment of goodwill will be recorded in earnings. The impairment test determines whether the fair value of the reporting unit exceeds the net carrying amount of this reporting unit at the valuation date. If the fair value exceeds the carrying amount, there is no impairment. If the carrying amount exceeds the fair value, the reporting unit is subject to a second impairment test to calculate the estimated value of goodwill to determine whether it is lower than the carrying amount.

The estimated fair value of goodwill is calculated using the same method used to determine the fair value of goodwill at the acquisition date at the time of a business combination, i.e., the excess fair value of the reporting unit over the value of identifiable assets acquired from the reporting unit.

The Company has elected to carry its annual impairment test during the third quarter of each year.

Impairment of long-lived assets

Fixed assets and intangible assets are tested for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. The carrying amount of a long-lived asset is not recoverable when it exceeds the sum of the undiscounted cash flows expected from its use and eventual disposal. In such a case, an impairment loss must be recognized and is equivalent to the excess of the carrying amount of a long-lived asset over its fair value.

Share issue expenses

Equity instrument issue expenses are applied against the consideration received for shares issued.

Revenue recognition

Equipment sales are recognized when equipment is received and accepted by customers and income from rendering services is recognized as services are rendered to customers.

Revenues and profits on drinking and wastewater treatment system contracts, which extend over a long period of time, are recognized using the percentage-of-completion method. Under this method, contract income and profit are recognized proportionately with the degree of completion of work. The degree of completion is determined based on the number of system installation phases completed. Contracts in process are valued taking into account labour costs, raw materials and overhead expenses, including estimated profits. Losses on contracts are recognized when total cost estimates indicate a loss.

Investment income is recognized using the accrual method of accounting and more specifically as follows:

Interest income is recognized based on the number of days the investment was held during the year and is calculated using the effective interest method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Research and Development Expenses and Tax Credits for a Company Established under the Carrefour de la Nouvelle Économie (“CNE”) relating to Research and Development

Research and development costs are expensed as incurred. However, development costs are deferred when they meet generally accepted criteria for deferral to the extent that their recovery is reasonably assured.

Tax credits to a company established under the CNE relating to research and development are accounted for during the year in which the costs are incurred, provided that the Company is reasonably certain that the credits will be received.

These tax credits must be examined by the tax authorities and it is possible that the amounts granted will differ from the amounts recorded.

Stock-based compensation and other stock-based payments

The Company offers a stock option plan described in note 13. The Company uses the fair value-based method to account for stock options granted to employees and directors. The fair value of stock options is determined using the Black-Scholes pricing model, and stock-based compensation costs are recognized in the consolidated statement of earnings and comprehensive loss over their vesting periods and are credited to contributed surplus.

Any consideration received by the Company upon the exercise of stock options is credited to share capital, and the contributed surplus component resulting from stock-based compensation is transferred to share capital upon the issuance of the shares.

Income taxes

The Company uses the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined according to differences between the carrying amounts and tax bases of assets and liabilities. They are measured by applying enacted or substantively enacted tax rates and laws at the date of the financial statements for the years in which the temporary differences are expected to reverse. The Company records a valuation allowance for future income tax assets if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized.

Earnings per share

Basic earnings per common share are computed by dividing the net earnings available to common shareholders by the weighted average number of common shares outstanding during the year. Diluted earnings per share are calculated giving effect to the potential dilution that could occur if the stock options and warrants to issue common shares were exercised or converted into common shares at the later of the beginning of the year or the issuance date. The treasury stock method is used to determine the dilutive effect of stock options and warrants.

Changes in accounting policies in effect

On July 1, 2009, the Company adopted Section 3064, “Goodwill and Intangible Assets” of the Canadian Institute of Chartered Accountants (“CICA”) Handbook. This section establishes standards for the recognition, measurement, and disclosure of goodwill and intangible assets. This section replaces Section 3062, “Goodwill and Other Intangible Assets” and Section 3450,“Research and Development Costs”. The adoption of this section had no impact on the Company’s consolidated financial statements and results of operations.

Future accounting changes

The CICA published the following sections of the CICA Handbook that apply to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011 :

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

a) Section 1582, “Business Combinations”, which replaces the former Section 1581 with the same title, establishes standards for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS 3, “Business Combinations”.

b) Section 1601, “Consolidated Financial Statements”, which replaces the former Section 1600 with the same title, establishes standards for the preparation of consolidated financial statements.

c) Section 1602, “Non-Controlling Interests”. This new section establishes standards on accounting for non-controlling interests in a subsidiary in consolidated financial statements prepared subsequent to a business combination. It is equivalent to the corresponding provisions of International Accounting Standard IAS 27, “Consolidated and Separate Financial Statements”.

The Company is presently evaluating the impact of these new standards on its financial statements.

3. Business Acquisitions

a) Professional Water Technologies

On June 17, 2009, H_2O Innovation Inc. completed the acquisition of substantially all of the assets of Professional Water Technologies ("PWT") through Membrane Systems Inc., an indirectly wholly-owned U.S. subsidiary of H_2O Innovation. PWT manufactures state-of-the-art products for maintaining and operating membrane filtration systems.

The total consideration of $4,606,746 includes a payment of $4,207,270 (US$3,700,000) in cash. The purchase price will be increased by a maximum of US$2,000,000 if accrued sales reach US$13,100,000 within the 24-month period following the closing of the transaction. Goodwill will be adjusted by any additional consideration. Acquisition costs totalling $50,411 (US$44,333) are in addition to the purchase price.

Allocation of the purchase price was evaluated at the acquisition date. The results of operations of the acquired company are included in the consolidated earnings since June 17, 2009, the acquisition date. The estimated fair value of the assets acquired and liabilities assumed are detailed as follows, at the Canadian dollar equivalent on the acquisition date:

Assets	$
Accounts receivable	484,698
Inventories	123,257
Fixed assets	39,799
Other assets	11,435
Intellectual property	2,581,217
Trademarks	511,695
Distribution network	864,196
Goodwill	281,073
Total assets acquired	4,897,370
Current liabilities	
Accounts payable	134,467
Notes payable	156,157
	290,624
Final acquisition price	4,606,746

During the year, the Company recorded a provision of $564,049 (US$529,822) as earn-out payment related to the acquisition of PWT. This amount is included in the other accrued liabilities and accounts payable and the counterpart is recorded as goodwill.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

b) Itasca Systems, Inc.

On July 3, 2008, H_2O Innovation Inc. completed the acquisition of all of the outstanding shares of Itasca Systems, Inc. ("Itasca") through H_2O Innovation USA Inc., a wholly-owned subsidiary of H_2O Innovation Inc.. Itasca specializes in treating industrial process water, notably for the energy sector.

The total consideration of $17,027,693 is equal to the payment of $9,644,670 (US$9,450,000) in cash, the bank loan assumed of $27,259, the issuance of 10,476,718 H_2O Innovation common shares and acquisition costs of $163,596. The value attributed to the common shares issued is $7,192,168 and was calculated according to the market price of the issued shares on the date on which the terms and conditions of the combination were agreed upon and disclosed, taking into consideration the potential price fluctuations resulting from the minimum holding period and number of securities that changed hands.

Allocation of the purchase price was evaluated at the acquisition date. The results of operations of the acquired company are included in the consolidated earnings since July 3, 2008, the acquisition date. The estimated fair value of the assets acquired and liabilities assumed are detailed as follows, at the Canadian dollar equivalent on the acquisition date:

Assets	$
Accounts receivable	1,516,397
Work in process	665,459
Inventories	405,204
Prepaid expenses	38,571
Fixed assets	121,917
Software	12,220
Other assets	12,120
Technologies	1,102,248
Customer relations	2,602,530
Distribution network	724,626
Backlog	214,326
Goodwill (i)	12,358,313
Future income taxes	430,696
Total assets acquired	20,204,627
Current Liabilities	
Bank loan	27,259
Accounts payable	1,216,090
Deferred rent	76,093
Future income taxes	1,857,492
	3,176,934
Final acquisition price	17,027,693

(i) Goodwill is not deductible for tax purposes.

c) During the year, the Company recorded a provision of $779,830 (US$732,510) as earn-out payment related to the acquisition of Membrane Systems Inc. This amount is included in the other accrued liabilities and accounts payable and the counterpart is recorded as goodwill.

d) During the year, the Company recorded a provision of $151,432 (US$142,243) as earn-out payment related to the acquisition of Wastewater Technology Inc. This amount is included in the other accrued liabilities and accounts payable and the counterpart is recorded as goodwill.

4. Interest in a Joint Venture

In February 2010, the Company get involved in a joint venture with Chembond Chemicals Limited of Mumbai, a leading manufacturer and supplier of speciality performance chemicals.

The accounts resulting from that investment have been consolidated with those of the Company using the proportionate consolidation method. The Company holds an interest of 49%. The joint venture began its operations in March 2010.

The following items correspond to the share in assets, liabilities, revenues and expenses and cash flows of the joint venture, which is included in these consolidated financial statements:

	2010
	$
Earnings	
Revenues	**14,711**
Expenses	**37,762**
Net loss for the four-month period	**(23,051)**
Cash flows	
Change in working capital items	**4,637**
Acquisition of fixed assets	**(3,764)**
Balance sheet	
Current assets	**90,830**
Long-term assets	**3,764**
Current liabilities	**9,139**

5. Held-for-trading Investments

As at June 30	**2010**	2009
	$	$
Guaranteed deposit certificates held as collateral for letters of credit, bearing interest from 0.40% to 0.45% (0.15% as at June 30, 2009) and maturing in July 2010	**1,250,318**	2,000,214
Guaranteed deposit certificate in escrow for sales contract execution and performance, bearing interest at 0.15% (from 0.20% to 1.70% as at June 30, 2009) and maturing in September 2010	**16,433**	20,856
	1,266,751	2,021,070

6. Held-to-maturity Investment

As at June 30	**2010**	2009
	$	$
Guaranteed deposit certificate in escrow for sales tax, bearing interest at 0.25% and maturing in August 2010	**39,908**	44,077

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

7. Accounts Receivable

As at June 30	2010	2009
	$	$
Accounts receivable	4,444,395	9,837,927
Allowance for doubtful accounts	(25,724)	(71,418)
	4,418,671	9,766,509
Tax credits receivable	97,637	186,579
Other receivables	340,977	270,678
	4,857,285	10,223,766

8. Inventories

As at June 30	2010	2009
	$	$
Raw materials	972,331	1,161,575
Finished goods	942,776	623,363
	1,915,107	1,784,938

9. Fixed Assets

As at June 30, 2010	Cost	Accumulated depreciation	Net
	$	$	$
Land	90,579	-	90,579
Buildings	1,799,033	539,208	1,259,825
Machinery and equipment	1,522,837	1,133,453	389,384
Computer equipment	643,389	371,405	271,984
Furniture, fixtures and office equipment	289,838	174,584	115,254
Automotive equipment	325,070	181,391	143,679
Leasehold improvements	202,734	22,324	180,410
	4,873,480	2,422,365	2,451,115

As at June 30, 2009	Cost	Accumulated depreciation	Net
	$	$	$
Land	115,682	-	115,682
Buildings	2,043,469	568,184	1,475,285
Machinery and equipment	1,468,676	1,036,567	432,109
Computer equipment	503,624	316,921	186,703
Furniture, fixtures and office equipment	254,591	150,811	103,780
Automotive equipment	306,208	161,950	144,258
Leasehold improvements	23,310	11,447	11,863
	4,715,560	2,245,880	2,469,680

10. Intangible Assets

As at June 30, 2010	**Cost**	**Accumulated amortization**	**Net**
	$	**$**	**$**
Software	**384,954**	**180,561**	**204,393**
Patents (i)	**3,754,757**	**847,870**	**2,906,887**
Rights on technologies	**377,592**	**284,884**	**92,708**
Technologies (i)	**1,102,248**	**860,968**	**241,280**
Trademarks (i)	**1,064,879**	**616,751**	**448,128**
Customer relations	**3,696,780**	**624,320**	**3,072,460**
Distribution network (i)	**2,102,283**	**1,157,718**	**944,565**
Backlog	**214,326**	**214,326**	**-**
Intellectual property	**2,581,217**	**177,817**	**2,403,400**
	15,279,036	**4,965,215**	**10,313,821**

As at June 30, 2009	Cost	Accumulated amortization	Net
	$	$	$
Software	309,337	140,825	168,512
Patents	3,754,757	414,827	3,339,930
Rights on technologies	548,947	325,758	223,189
Technologies	1,102,248	73,484	1,028,764
Trademarks	1,061,233	102,813	958,420
Customer relations	3,696,780	373,200	3,323,580
Distribution network	2,102,283	275,014	1,827,269
Backlog	214,326	214,326	-
Intellectual Property	2,581,217	5,736	2,575,481
	15,371,128	1,925,983	13,445,145

(i) Upon the impairment test made during the year (note 11), recoverability of intangible assets was also tested. Following this test, an impairment of intangible assets in the amount of $1,763,861 was recognized. The impairment charge was allocated as follows: $176,861 due to abandonment of a patent, $402,000 due to a non used trademark, $714,000 due to the decrease of cash flow generated by a technology, and $471,000 to the lost of a distribution network. The impairment charge was fully reflected in accumulated amortization.

These impairment charges generated a future income tax recovery of $634,800.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

11. Goodwill

	$
Balance as at June 30, 2008	1,976,828
Acquisition - Itasca Systems Inc.	12,358,313
Acquisition - Professional Water Technologies	281,073
Balance as at June 30, 2009	14,616,214
Earn-out payments – Membrane Systems Inc.	**779,830**
Earn-out payments – Professional Water Technologies	**564,049**
Earn-out payments – Wastewater Technology Inc.	**151,432**
Purchase price adjustment – Professional Water Technologies	**(326,808)**
Impairment of goodwill (i)	**(4,916,000)**
Others	**32,726**
Balance as at June 30, 2010	**10,901,443**

(i) Goodwill is subject to an impairment test in the third quarter of each fiscal year. Concerning the measurement of the fair value of the Company's reporting unit, quoted market prices in active markets are considered the best evidence of fair value. Afterwards, in second rank, inputs other than quoted prices in active markets that are based on observable market data should be used. Finally, the operating unit's own assumptions about assumptions used by marketplace participants (i.e., the present value of cash flows) should be used when the first two information sources are not conclusive or are not available.

In the third quarter of fiscal 2010, the Company performed its annual impairment test for goodwill. Recoverability of goodwill is determined at the Company's single reporting unit level, using a two-step approach. First, the carrying value of the reporting unit is compared to its fair value. If the net carrying value of the reporting unit exceeds its fair value, the second step is performed to determine the amount of the impairment loss. Following the decrease in the Company's stock price in June 2010, we came to the conclusion that the net carrying value of our reporting unit exceeded its fair value for fiscal 2010, and recorded an impairment charge of $4,916,000 in fiscal 2010, to bring the goodwill to its fair value. The fair value of the reporting unit was determined based on a combination of market capitalization and discounted cash flows. Discounted cash flows were estimated over periods varying from five to ten years and based on a discount rate of 14.25%.

12. Bank Loans

The bank loans for an authorized amount of $2,000,000 and US$1,000,000 bearing interest at CDN prime rate plus 1% (3.50% as at June 30, 2010) and at US prime rate plus 1% (4,75% as at June 30, 2010) are secured by an assignment of book debts and inventories. These bank loans are renegotiable in November 2010 and are secured in part by Export Development Canada ("EDC"). Under the credit agreement, the Company is required to respect certain covenants which are respected as at June 30, 2010.

The Company has a credit facility enabling it to issue letters of credit for a maximum amount of $2,000,000. This credit facility bears interest at prime rate plus 1.0% (3.50% as at June 30, 2010) and is renegotiable on November 30, 2010. The credit facility is secured by a guaranteed deposit certificate ($1,250,318 as at June 30, 2010). As at June 30, 2010, the Company issued $1,031,755 in letters of credit under this credit facility. Also, the Company issued $259,654 of credit letters secured by EDC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

13. Accounts Payable and Accrued Liabilities

As at June 30	2010	2009
	$	$
Trade accounts payable	**2,053,959**	4,022,974
Other accrued liabilities and accounts payable	**2,761,294**	1,625,709
	4,815,253	5,648,683

14. Long-Term Debt

As at June 30	2010	2009
	$	$
Loans reimbursed during the year (i)	**-**	2,808,590
Unsecured loans (ii)	**2,479,070**	2,523,125
Equity component	**(229,454)**	(229,454)
Financing expenses	**(173,726)**	(173,726)
Accretion of the debt component	**60,297**	-
Amortization of financing expenses	**45,549**	-
Impact of foreign exchange rate	**7,232**	-
	2,188,968	4,928,535
Less : Current portion	**(619,768)**	(875,000)
Long-term debt	**1,569,200**	4,053,535

(i) During the year, an amount of $27,695 has been recorded as accretion of the debt component ($13,580 for the precedent year) and an amount of $7,466 has been recorded as amortization of financing expenses ($3,661$ for the precedent year)

(ii) Loans issued in June 2009 having a par value of $2,000,000 and US$450,000, unsecured, bearing interest at the rate of 11% (effective rate of 19.9%) payable in 48 equal instalments of $41,667 and US$9,375, principal only, maturing on June 1, 2014. The Company had a capital leave the first year. Of these amounts, US$282,112 is owed to some Company shareholders. Upon issue of these loans, the Company issued 1,250,000 warrants, one half warrant per dollar of loan entitling the holder to the purchase of one common share at a price varying from $0.80 to $1.10 until June 2013. The Company paid $173,726 in financing expenses, which were recorded as a reduction of the debt component.

The principal instalments due on the long-term debt over each of the next four years amount to $619,768.

15. Convertible Debenture

	2010	2009
	$	$
Convertible debenture (i)	**1,500,000**	1,500,000
Equity component	**(301,023)**	(301,023)
Financing expenses	**(53,663)**	(53,663)
Accretion of the debt component	**177,562**	79,178
Amortization of financing expenses	**31,654**	14,115
	1,354,530	1,238,607

(i) Debenture issued in July 2009 with a par value of $1,500,000, unsecured, bearing interest at the rate of 10% (effective rate of 22.1%), maturing on July 9, 2011. The Company paid $53,663 in financing expenses, which were recorded as a reduction of the debt component. The debenture is convertible at any time, in whole or in part, into common shares of the Company. The conversion price is $0.95 if conversion occurs before July 10, 2010 and $1.045 if conversion occurs between July 10, 2010 and the maturity date.

The principal installment due on the convertible debenture amounts to $1,500,000 in July 2011. (See the subsequent event in note 27).

16. Capital Stock

Authorized

Unlimited number of common shares, without par value

As at June 30, 2010	**Number**	**Amount**
		$
Issued and paid at the beginning of the year	**55,139,948**	**43,765,031**
Shares issued in connection with private financing (i)	**4,955,884**	**2,066,825**
Shares issued pursuant to the stock option plan	**25,000**	**13,000**
	60,120,832	**45,844,856**
Shares to be issued		
In settlement of business acquisition	**6,895**	**13,789**
Balance - End of year	**60,127,727**	**45,858,645**

As at June 30, 2009	Number	Amount
		$
Issued and paid at the beginning of the year	36,890,503	33,714,355
Shares issued in settlement of the acquisition of Itasca (note 3)	10,476,718	7,159,434
Shares issued in connection with private financing (ii)	7,772,727	2,891,242
	55,139,948	43,765,031
Shares to be issued		
In settlement of business acquisition	6,895	13,789
Balance - End of year	55,146,843	43,778,820

(i) During the year, the Company completed a share financing with various investors and issued 4,955,884 shares at $0.425 each.

Shares issue expenses amounting to $39,425 have been reflected in the capital stock.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(ii) During the precedent year, the Company completed two share and warrant financings with various investors. The Company issued 7,772,727 units at $0.55 each. Each unit consists of one common share and one warrant, the latter entitling to subscribe for a common share for a price of $0.85 over 30 months. The fair value of the warrants, using the proportional allocation method, has been established to $1,098,868 or $0.15 per warrant. The Company issued 157,150 units bearing the same characteristics as fees for these financings for a fair value of $93,680; no shares were included in this payment.

The fair value of each warrant and each unit granted was estimated at the grant date using the Black-Scholes option pricing model. The valuation was carried out using the following weighted averages: expected volatility of 80.6%, risk-free rate of 1.83%, expected life of 30 months and no expected dividend.

Share issue including warrants amounting to $191,210 have been reflected in the capital stock. The fair value of warrants has been applies against proceeds from issuance and the consideration has been accounted for as contributed surplus on the balance sheet.

Stock-Based Compensation Plan

The Company has established a stock option plan whereby the Board of Directors may grant stock options to directors, executive officers, key employees and consultants providing services to the Company. The Board of Directors determines, at its discretion, the vesting terms, if applicable, the expiry date of options and the number of options to be granted. The maximum number of shares that may be issued under the plan increased from 3,400,000 to 5,500,000 during the year ended June 30, 2010.

The table below shows the assumptions used in determining stock-based compensation costs under the Black & Scholes option pricing model:

YEARS ENDED JUNE 30,	**2010**	2009
NUMBER OF STOCK OPTIONS	**205,000**	207,000
EXPECTED DIVIDEND YIELD	**0%**	0%
EXPECTED VOLATILITY	**81.73%**	80.52%
RISK-FREE INTEREST RATE	**3.25%**	2.36%
WEIGHTED AVERAGE EXPECTED LIFE (YEARS)	**10**	5
WEIGHTED AVERAGE FAIR VALUE AT THE GRANT DATE	**$0.47**	$0.41

For the year ended June 30, 2010, the Company recorded $82,992 ($333,662 in 2009) as stock-based compensation for options granted to its directors, officers and key employees.

The following table summarizes the situation of the Company's stock-based compensation plan as at June 30, 2010 and June 30, 2009 and the change during the years ended on these dates:

Years ended June 30		**2010**		2009
	Number	**Weighted average exercise price**	Number	Weighted average exercise price
		$		$
Outstanding - Beginning of year	**1,815,000**	**1.15**	1,671,000	1.26
Granted	**205,000**	**0.75**	207,000	0.41
Exercised	**(25,000)**	**0.32**	-	-
Expired	**-**	**-**	(25,000)	2.30
Forfeited	**(45,000)**	**1.48**	(38,000)	1.26
Outstanding - End of year	**1,950,000**	**1.11**	1,815,000	1.15
Exercisable - End of year	**1,796,250**	**1.14**	1,691,639	1.21

As at June 30, 2010, the following stock options were granted:

Exercise price	Holders	Number of shares	Weighted average remaining life (years)	Weighted average exercise price
$				$
0.32	Directors	150,000	3.45	0.32
0.75	Directors	205,000	9.42	0.75
0.90	Directors	262,000	2.99	0.90
1.20	Directors	260,000	1.52	1.20
1.50	Directors	324,500	2.14	1.50
0.90	Employees	270,000	2.99	0.90
1.20	Employees	125,000	1.52	1.20
1.50	Employees	333,500	2.14	1.50
1.85	Employees	20,000	1.91	1.85
		1,950,000	3.11	1.11

As at June 30, 2010, the following stock options could be exercised:

Exercise price	Number of shares	Weighted average exercise price
$		$
0.32	150,000	0.32
0.75	51,250	0.75
0.90	532,000	0.90
1.20	385,000	1.20
1.50	658,000	1.50
1.85	20,000	1.85
	1,796,250	1.14

Warrants

In the course of its financing transactions made during previous years, the Company issued warrants entitling them the right to acquire shares at a predetermined price. Each warrant issued entitles the holder to acquire one common share of the Company.

The warrants outstanding as at June 30, 2010 and June 30, 2009 and the change during the years ended on those dates are summarized in the following table:

Years ended June 30		**2010**		2009
	Number	**Weighted average exercise price**	Number	Weighted average exercise price
		$		$
Outstanding, beginning of year	**9,179,877**	**0.88**	9,344,179	2.30
Granted	**-**	**-**	9,179,877	0.88
Expired	**-**	**-**	(9,344,179)	2.30
Outstanding, end of year	**9,179,877**	**0.88**	9,179,877	0.88

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

As at June 30, 2010, the following warrants were granted:

Maturity date	Number of warrants	Exercise price
December 2011	**7,929,877**	$0.85
June 2013	**1,250,000**	$0.90 on or before June 30, 2011 $1.00 on or before June 30, 2012 $1.10 on or before June 30, 2013
	9,179,877	

17. Income Taxes

The income tax provision is as follows:

	2010		2009	
	$	**%**	$	%
Income taxes at statutory rates	**(3,658,634)**	**30.07**	(246,353)	30.90
Rate differential	**(454,119)**	**3.73**	1,045,924	(131.19)
Valuation allowance	**(377,258)**	**3.10**	(1,886,536)	236.63
Stock-based compensation	**24,597**	**(0.21)**	103,102	(12.93)
Tax losses expired during the year	**608,753**	**(5.00)**	410,285	(51.46)
Items not affecting earnings	**77,263**	**(0.64)**	(144,402)	18.11
Tax credits	**-**	**-**	(64,563)	8.10
Gain on debt settlement	**142,913**	**(1.17)**	-	-
Withholding taxes on cross-border interest	**-**	**-**	64,635	(8.11)
Non-deductible goodwill impairment	**1,479,820**	**(12.16)**	-	-
Non-deductible items and other	**(12,218)**	**0.10**	(14,203)	1.78
	(2,168,523)	**17.82**	(732,111)	91.83

Future income tax assets valued at $6,325,403 as at June 30, 2010 ($6,702,258 as at June 30, 2009) have not been reflected in the financial statements. These items are summarized as follows:

	2010	2009
FUTURE INCOME TAX ASSETS	**$**	$
Development and exploration expenses	**1,341,000**	1,358,000
Non-capital losses	**4,153,000**	3,685,000
Capital losses	**66,000**	78,000
Research and development expenses	**569,000**	561,000
Fixed assets	**777,000**	904,000
Intangible assets	**725 000**	467,000
Financing expenses	**161,000**	315,000
U.S. interests not deducted and deferred	**748,000**	280,000
Other assets	**84,000**	11,000
	8,624,000	7,659,000
LIABILITIES ON FUTURE INCOME TAXES		
Tax credits	**(28,000)**	(55,000)
Intangible assets	**(2,264,000)**	(3,079,000)
	(2,292,000)	(3,134,000)
	6,332,000	4,525,000
Valuation allowance	**(6,325,403)**	(6,702,258)
Net future income tax assets (liabilities) recognized	**6,597**	(2,177,258)

DETAIL OF FUTURE INCOME TAX ASSETS AND LIABILITIES ON THE BALANCE SHEET

Future income tax assets – current	**-**	375,376
Future income tax assets – long-term	**6,597**	-
Future income tax liabilities – long-term	**-**	(2,552,634)
Net future income tax assets (liabilities) recognized	**6,597**	(2,177,258)

Losses likely to reduce income taxes in future years are detailed as follows:

Losses carried over expiring within the following years:	Date	Provincial	Federal	USA
		$	$	$
	2014	3,063,000	3,078,000	-
	2015	1,236,000	1,103,000	-
	2016	2,277,000	2,277,000	-
	2027	2,365,000	2,330,000	-
	2028	2,618,000	2,619,000	26,000
	2029	1,000	1,000	-
	2030	674,000	674,000	2,198,000
		12,234,000	12,082,000	2,224,000

In addition, the Company has available investment tax credits valued at approximately $400,000 maturing at different dates from 2020.

18. Information on Consolidated Earnings

	2010	2009
	$	$
Research and development expenses	**33,989**	74,639

19. Cost of goods sold

The following table presents the reconciliation of the cost of goods sold reflected in earnings to the inventory amount charged to expense during the year.

	2010	2009
	$	$
Cost of goods sold	**20,721,550**	23,793,922
Depreciation of fixed assets related to the transformation of inventories	**147,236**	157,906
Inventory amount charged to expense	**20,868,786**	23,951,828

20. Earnings Per Share

The following table sets out the weighted average basic and diluted number of outstanding shares used to compute the basic and diluted loss per share:

As at June 30	**2010**	2009
Basic and diluted weighted average number of share outstanding	**55,160,147**	47,722,705

For the years ended June 30, 2010 and 2009, there was no difference in the basic and diluted weighted average number of shares outstanding, since the effect of the stock options, warrants and convertible debenture would have been antidilutive. Accordingly, the diluted loss per share for these years is calculated using the basic weighted average number of shares outstanding.

However, should the Company's basic earnings per share have been positive, some options would have been dilutive and would have resulted in the addition of 150,000 shares for the year ended June 30, 2010 (175,000 shares for the year ended June 30, 2009), to the weighted average number of shares outstanding used in the diluted earnings per share calculation.

21. Cash Flows

a) The change in non-cash working capital items is as follows:

	2010	2009
	$	$
Accounts receivable	**5,366,481**	(3,324,692)
Inventories	**(130,169)**	(280,018)
Work in process	**(1,125,687)**	518,168
Prepaid expenses	**(49,992)**	53,450
Accounts payable	**(2,046,302)**	811,822
Billings in excess of work in process	**(1,112,501)**	940,580
Deferred rents	**(20,031)**	876
	881,799	(1,279,814)

b) Items not affecting cash related to operating and investing activities:

As at June 30	**2010**	2009
	$	$
Acquisition of fixed assets included in accounts payable and accrued liabilities	**11,643**	-
Business acquisitions included in accounts payable and accrued liabilities	**1,201,229**	-

c) Additional information

As at June 30	**2010**	2009
	$	$
Interest paid	**553,909**	275,205

22. Commitments

The Company has entered into long-term lease agreements expiring in 2010, 2012, 2013 and 2017 which call for lease payments of $2,044,070 for the rental of space. The minimum annual lease payments over the next five years are $484,300 in 2011, $412,400 in 2012, $352,600 in 2013 and $191,600 in 2014 and $196,200 in 2015.

23. Financial Instruments

Fair value

Amendments to 3862, “Financial Instruments – Disclosures”, establish a fair value hierarchy which requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company primarily applies the market approach for recurring fair value measurements. The Section describes three input levels that may be used to measure fair value:

Level 1
Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2
Inputs other than quoted prices included in 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
Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The carrying amount and estimated fair value of financial instruments are as follows:

Financial instruments whose carrying value approximates fair value

Cash and cash equivalents, held-for-trading investments, held-to-maturity investment, accounts receivable and accounts payable and accrued liabilities are financial instruments whose fair value approximates their carrying value due to their short-term maturity. The input level used by the Company to measure fair value of its cash and cash equivalents, held-for-trading investments and held-to-maturity investment is a Level 1 because they are valued using quoted market prices.

Long-term debt and convertible debenture

The fair value of the long-term debt and the convertible debenture has been established by discounting the future cash flows at an interest rate to which the Company would currently be able to obtain for loans with similar maturity dates and terms. The fair value of the long-term debt is $ 2,188,968 ($4,928,535 as at June 30, 2009) and the fair value of the convertible debenture is $1,354,530 ($1,238,607 as at June 30, 2009).

Credit risk

Credit risk relates to the risk that a party to a financial instrument will not fulfil some or all of its obligations, thereby causing the Company to sustain a financial loss. The main risk relates to accounts receivable. To manage credit risk from accounts receivable, the Company records allowances, determined on a client-per-client basis, at the balance sheet date to account for potential losses.

The carrying amount on the balance sheet of the Company's financial assets exposed to credit risk represents the maximum amount exposed to credit risk.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following table summarizes the Company's exposure to credit risk:

AS AT JUNE 30	2010	2009
	$	$
CASH AND CASH EQUIVALENTS	2,672,375	5,594,406
HELD-FOR-TRADING INVESTMENTS	1,266,751	2,021,070
HELD-TO-MATURITY INVESTMENT	39,908	44,077
ACCOUNTS RECEIVABLE	4,857,285	10,223,766

Management estimates that the credit quality of all the above-mentioned financial assets that are not impaired or overdue is good.

The Company is also exposed to credit risk due to cash, its deposit certificate and investments certificates. The Company has $3,979,034 ($7,659,553 in 2009) in cash and investments with banking institutions that the Company considers at a low risk for loss.

Liquidity risk

Liquidity risk is the risk that the Company will be unable to fulfil its obligations on a timely basis or at reasonable cost. The Company manages its liquidity risk by monitoring its operating requirements and using various funding sources to ensure its financial flexibility. The Company prepares budgets and cash forecasts to ensure that it have sufficient funds to fulfil its obligations.

For its investing activities, the Company will evaluate its liquidity needs when applicable and take the necessary action.

The following table presents the financial liability instalments payable when contractually due, excluding future interest payments but including accrued interest as at June 30, 2010:

	CARRYING AMOUNT	0 - 1 YEAR	1 - 2 YEARS	2 - 3 YEARS	4 YEARS AND MORE
	$	$	$	$	$
ACCOUNTS PAYABLE	4,815,253	4,815,253			

LONG-TERM DEBT	2,188,968	619,768	619,768	619,768	619,768
CONVERTIBLE DEBENTURE (I) AND (II)	1,354,530		1,500,000		
TOTAL	8,358,751	5,435,021	2,119,768	619,768	619,768

(i) The amount recorded in the "Convertible debenture" line of the table includes an equity component of the convertible debenture.

(ii) In July 2010, the repayment terms of the convertible debenture have been modified (See subsequent event in note 27).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Exchange risk

The Company is exposed to exchange risk as a result of its U.S. dollar purchases and sales and also as a result of its foreign subsidiary net assets. To limit the impact of fluctuations of the Canadian dollar over the U.S. dollar, the Company matches, in general and when possible, the cash receipts in a foreign currency with the cash disbursements in the same foreign currency. The Company does not use derivative financial instruments to cover the variability of cash flows in foreign currencies.

As at June 30, 2010, if the Canadian dollar had increased or decreased by five (5) cents compared to the U.S. dollar, assuming that all other variables remained constant, net loss for the year ended June 30, 2010 would have been greater or lesser by approximately $80,000 ($116,600 as at June 30, 2009).

The financial assets and liabilities denominated in U.S. dollars are as follows:

AS AT JUNE 30	**2010**	2009
	US$	US$
FINANCIAL ASSETS		
CASH	**1,849,703**	1,633,211
INVESTMENTS	**52,922**	53,276
ACCOUNTS RECEIVABLE	**3,149,411**	7,291,369
	5,052,036	8,977,856
FINANCIAL LIABILITIES		
ACCOUNTS PAYABLE	**3,180,522**	4,244,179
LONG-TERM DEBT	**450,000**	450,000
	3,630,522	4,694,179

Interest rate risk

In the normal course of business, the Company is exposed to interest rate fluctuation risk as a result of the floating-rate loans and debts receivable and loans payable. The Company manages its interest rate fluctuation exposure by allocating its financial debt between fixed and floating-rate instruments.

The deposit certificates, investment certificates, investments, unsecured loans and the convertible debenture bear interest at fixed rates and the Company is, therefore, exposed to the risk of changes in fair value resulting from interest rate fluctuations.

The bank loans bear interest at floating rates and the Company is, therefore, exposed to the cash flow risks resulting from interest rate fluctuations.

As at June 30, 2010 and 2009, a 25-basis-point increase or decrease in interest rates, assuming that all other variables remain constant, would not have had a significant impact on the Company's net loss. These changes were retained because they are considered reasonably possible according to observations and the economic situation.

24. Segment Information

The Company operates in one reportable operating segment consisting of delivering drinking water and process water production and wastewater treatment systems, including related services. Detailed information for the Company's markets is as follows:

Years ended June 30	**2010**	2009
	$	$
Revenue according to geographic location		
Canada	**7,360,869**	5,968,648
United States	**17,268,619**	25,037,170
Mexico	**275,610**	-
Egypt	**1,053,227**	169,176
China	**771,020**	-
Dominican Republic	**202,980**	-
Australia	**209,956**	-
India	**14,111**	-
Other	**571,164**	40,796
	27,727,556	31,215,790

Revenue is attributed to the various countries according to the customer's country of residence.

Years ended June 30	**2010**	2009
	$	$
Fixed assets according to geographic location		
Canada	**1,995,916**	2,229,858
United States	**451,435**	239,822
India	**3,764**	-
	2,451,115	2,469,680

Years ended June 30	**2010**	2009
	$	$
Intangible assets according to geographic location		
Canada	**330,330**	638,482
United States	**9,983,491**	12,806,663
	10,313,821	13,445,145

Years ended June 30	**2010**	2009
	$	$
Goodwill according to geographic location		
United States	**10,901,443**	14,616,214

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

25. Capital Management

The Company's objective when managing capital is to maintain a flexible capital structure, which optimizes the cost of capital at an acceptable risk level. For capital management purposes, the Company defines its capital as follows: shareholders' equity, long-term debt, convertible debenture less cash and cash equivalents, held-for-trading investments and held-to-maturity investment. The Company monitors capital in light of its monthly needs and obligations linked to its financial liabilities.

The bank loan includes certain covenants regarding among others, the working capital, the debt coverage ratio and the debt ratio. Management is conducting a thorough follow-up of these ratios, which are all respected as at June 30, 2010. Except for covenants relating to the bank loan, the Company is not subject to any other capital requirement imposed by a third party.

26. Differences between International Financial Reporting Standards and Canadian GAAP

The consolidated financial statements have been prepared according to Canadian GAAP. In several areas, International Financial Reporting Standards ("IFRS") established by the International Accounting Standards Board vary from Canadian GAAP.

Other information

On September 21, 2010, the Board reviewed the consolidated financial statements and authorized its publication. These consolidated financial statements will be presented for adoption during the Shareholders' Meeting scheduled to take place on November 10, 2010.

27. Subsequent Event

Modification of the repayment terms of the convertible debenture

In July 2010, the convertible debenture repayment terms, which initially stipulated one $1,500,000 installment payable on July 9, 2011, were modified as follows: six $250,000 installment payable every three months from July 9, 2011 to October 9, 2012. The applicable annual interest rate of 10% was increased by 1% to reach 11% as from July 9, 2010. The other debenture terms remain unchanged.

28. Comparative Figures

Certain comparative figures of previous year have been reclassified to conform with the presentation adopted in the current year.

GENERAL INFORMATION

Directors and Officers

Philippe Gervais, Chairman of the Board (1)
Frédéric Dugré, President, Chief Executive Officer and Director
John G. Booth, Director (2)
Élaine C. Phénix, Director (1) (2)
André Duquenne, Director (1) (2)
Richard Hoel, Director (1)
Lisa Henthorne, Director
Marc Blanchet, Secretary of the Board

(1) Audit Committee
(2) Governance and Compensation Committee

Legal Counsel
McCarthy Tétrault S.E.N.C.R.L.

Auditors
PricewaterhouseCoopers LLP/S.R.L./S.E.N.C.R.L.

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