h2o innovation®
du savoir à partager . knowledge to share®

Interim financial report
Third quarter ended
March 31, 2011

www.h2oinnovation.com
investor@h2oinnovation.com

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

MANAGEMENT REPORT

Dear Shareholders,

In this third quarter, our revenues, gross margin, and operating earnings all increased. We recorded positive EBITDA[1], and our operating activities generated cash . significant improvements compared to the previous fiscal year and a solid progression from the previous quarter of the current fiscal year. This quarter's results are highlighted by growth in all our business lines and markets: equipment and systems, as well as services and consumables, in North America and internationally. They also include the first sizeable contribution from our Indian joint venture, which is also enjoying fast growth in bookings and revenues and cash flows generated from operating activities.

Our sales for the quarter amounted to $7.9 M, compared to $6.3 M for the corresponding quarter of the previous fiscal year, an increase of 26% or $1.6 M. On this higher level of sales, we have also generated a higher gross margin, at 33.0%, noticeably up compared to the same quarter ended March 31, 2010 when it was recorded at 25.4%. A high proportion of industrial systems sales compared to municipal projects in this quarter's revenue mix positively contributed to this quarter's margin, as also contributed a high level of sales of maple syrup production equipment, and services and consumables. At 31.6%, our gross margin for the nine-month period ended March 31, 2011 stays above the 30% mark and is five percentage points higher than that of the nine-month period ended March 31, 2010.

For a fifth consecutive quarter now, we secured more new bookings for equipment and systems than we recorded revenues of the same nature. Bookings of equipment and systems sales for the quarter amounted to $7.8 M, compared to $5.8 M in the third quarter of the previous fiscal year. These new bookings raised our sales backlog to $22.9 M as at March 31, 2011, significantly up compared to the third quarter of fiscal 2010 where it stood at $14.5 M. Our backlog also showed a $7.8 M increase compared to its level at the end of fiscal 2011 second quarter, when it amounted to $15.1 M. Our sales backlog now includes the backlog of H_2O Innovation India, proportionally to the Company's interest in the Indian joint venture.

At $2.1 M, the level of our selling, general and administrative ("SG&A") expenses was down by approximately $298,000 compared to the corresponding quarter of the previous fiscal year. For the nine-month period ended March 31, 2011, we show a reduction of more than $615,000 of SG&A expenses, compared to the same nine-month period of the 2010 fiscal year. This reduction and the increased efficiencies represented in part by increase in gross margin show how we have successfully implemented the cost reduction program announced in May 2010, without impacting any of our growth vectors.

[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 for the quarter was $390,901, compared to ($980,271) for the same period ended March 31, 2010 (including the effects of a mostly unrealized foreign exchange loss). Adjusted EBITDA for the quarter was $486,770 (excluding a $95,869 stock-based compensation expense), compared to ($793,208) for the corresponding quarter of the previous fiscal year. This is the second consecutive quarter during which we have recorded positive adjusted EBITDA.

The net loss of quarter has shrunk significantly, from ($1,558,567) or ($0.028 per share) for the third quarter of fiscal 2010 to only ($153,575) or ($0.003 per share). Net loss for the first nine months of the fiscal year is down more than $2.4 M compared to the nine-month period ended March 31, 2010.

The quarter's higher sales and gross margin – coupled with controlled costs and continuously improving project execution – enabled us to record positive earnings from operations and distance ourselves from the operating losses of the past few quarters. As we continue to grow total sales, we should shortly reach the level at which our activities produce net earnings. Sustained efforts from our sales teams along with better integration of our business lines in our sales offering have made it possible for our Company to produce these improved results.

Looking at our key markets and business lines, we note that market demand remains strong for our patented Bio-Wheel & Bio-Brane wastewater treatment technologies and water reuse systems in Western Canada, from small to mid-sized municipalities and First Nations communities. Demand for industrial process water and drinking water production systems was also strong in Western Canada, particularly in the mining and oil & gas markets. As is Western Canada, the Quebec municipal market continues to bring several promising sales opportunities for nanofiltration drinking water production systems.

We have also been successful recently on the international scene, securing contracts with energy and power generation customers for the supply of industrial water treatment systems in Northern Africa and Russia. Our intention is to build on these successes and continue growing our international activities in fast growing regions, where our reference list of 550 past projects is a substantial sales asset. With its new manufacturing plant, our Indian joint venture has also significantly reinforced its operations and we will directly feel the benefits as they continue growing and we continue making use of their capabilities to increase our competitiveness on international projects.

Our maple syrup equipment business line also recorded strong sales during the quarter, as producers prepared for the start of the season. A first in our history, we have added a U.S. maple syrup equipment distributor to our roster of sales representatives covering the maple syrup market, opening up a larger market for our historical business line.

With our base of steadily growing sales of services and consumables, H_2O Innovation India's contribution, our recent successes securing new contracts, and almost $23 M of equipment and systems sales in backlog, we are in a strong position to reach profitability very soon. We expect our revenues and earnings to continue their growth in the next quarters, with demand remaining strong from Western Canada, Quebec and the U.S. industrial market, as well as the mining and oil & gas industries. The building blocks we have assembled are truly starting to show their full potential.

Frédéric Dugré
President and CEO

MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE FINANCIAL SITUATION

In accordance with National Instrument 51-102 Continuous Disclosure Obligations, the following comments are intended to provide a review and an analysis of H_2O Innovationqs results of operations and financial position for the quarter ended March 31, 2011, in comparison with the corresponding period ended March 31, 2010. They should be read in conjunction with the consolidated financial statements and accompanying notes. Comparison of Balance sheets as at March 31, 2011 to those as at June 30, 2010 is also included. Certain statements set forth in this Managementqs 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 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 Managementqs Discussion and Analysis or in other communications as a result of new information, future events and other changes.

The following financial statements and the corresponding figures have not been reviewed by the Companyqs auditors. They have been prepared in accordance with Canadian generally accepted accounting principles. All figures in the present report are expressed in Canadian dollars, unless otherwise indicated.

VISION, MISSION & PROFILE

OUR VISION

Create sustained and growing value for our shareholders by becoming the best in North America, working through consulting engineers, at customizing water treatment solutions based on comprehensive analytical and strong technical capabilities that maximize the efficiency, performance and longevity of our customersqsystems.

OUR MISSION

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

OUR PROFILE

Building on 11 years of experience, H_2O Innovation designs, manufactures, and integrates state-of-the-art custom-built water treatment systems for the production of drinking water and industrial process water, the reclamation and reuse of water, and the treatment of wastewater in the municipal, commercial, institutional, industrial, oil & gas, mining, and energy markets. The Company also offers operating and maintenance solutions for membrane filtration and reverse osmosis systems. H_2O Innovation has approximately 100 employees, seven offices including three manufacturing plants in Canada and the United States and is a founding partner of H_2O Innovation India, a joint venture based in Mumbai, India. Shares of H_2O Innovation are listed on the TSX Venture Exchange (HEO) as well as on the NYSE Euronext Alternext Exchange (MNEMO: ALHEO). For more, visit www.h2oinnovation.com.

RESULTS OF OPERATIONS

Selected financial data
(Unaudited)

	Three-month periods ended March 31		Nine-month periods ended March 31	
	2011	**2010**	**2011**	**2010**
	$	$	$	$
Sales	7,950,587	6,312,349	20,711,959	21,806,201
Gross margin	2,625,933	1,603,062	6,536,607	5,680,641
Gross margin	33.0%	25.4%	31.6%	26.1%
Operating, selling, admin. and general expenses	2,122,272	2,420,690	6,080,590	6,695,877
Net loss	(153,575)	(1,558,567)	(1,345,398)	(3,777,477)
Basic and diluted loss per share	(0.003)	(0.028)	(0.022)	(0.068)
EBITDA	390,901	(980,271)	289,534	(2,035,663)
Adjusted EBITDA	486,770	(793,208)	496,075	(1,064,460)

Sales and gross margin

Results for the third quarter of fiscal 2011 show both the effects of a marked revival in our sales of equipment and systems over the last nine months and the impact of the cost reduction program initiated by the Company in May 2010. Sales revenues are up by more than 25% compared to the corresponding quarter of fiscal 2010 and up by 23.8% compared to the second quarter of the current fiscal year. The award of $7.8 M in new contracts during this quarter bring to $18.9 M the total of new contracts secured since the beginning of fiscal 2011 . a 49% increase compared to fiscal 2010. Additionally, the creation of H_2O Innovation India Ltd., announced on February 1, 2010, increases revenues from sales of equipment and systems by adding $2.6 M to the backlog, based on proportionate consolidation. The Companyqs backlog amounts to $22.9 M as at March 31, 2011, while it amounted to $14.5 M at the same date of the previous fiscal year . which represents a 58% increase over a twelve-month period.

The increase in revenues during this third quarter can be attributed to three factors: a strong growth in sales of services and consumables (totalling $3.4 M for the quarter), a slight increase in sales of equipment and systems (totalling $3.7 M) and the contribution of the Companyqs Indian joint-venture (amounting to $0.8 M). The commercial initiatives launched by our service teams to proactively solicit our clients, the new sales of specialty products for membrane filtration systems, and the addition of distributors in the northeast region of the United States and in Canada for our maple syrup business line generated a 21.4% increase in our sales of services and consumables compared to the previous quarter of the current fiscal year. Management is confident that revenues from the equipment and systems business line will soon increase, supported by the sustained growth of the Companyqs backlog, which will gradually turn into revenues over the next quarters. One year after its creation, the joint-venture H_2O Innovation India Ltd., which is held at 49% by the Company, brought $0.8 M of revenues during the quarter ended March 31, 2011. The first project deliveries together with the progression of the on-going Indian industrial projects start showing a positive impact on the Companyqs consolidated results.

For the nine-month period ended March 31, 2011, total sales amounted to $20.7 M, compared to $21.8 M for the corresponding nine-month period ended March 31, 2010. This gap is mainly due to the economic environment in which the Company evolved over the last months and to the delays between the award of new contracts and the recognition of their revenues.

The adding of new industrial projects and the major increase in sales of services and consumables, generally recurring in nature, positively impacted the Companyqs gross margin, which went up from 25.4% in the third quarter of fiscal 2010 to 33.0% in the corresponding quarter of the current fiscal year. The sustained efforts deployed by our teams to maximize the connexion between the equipment we manufacture and our consumables also contribute optimizing our gross margin . which is additionally reinforced by the increase in sales of systems to industrial customers.

Gross margin for the nine-month period ended March 31, 2011 increased to 31.6%, compared to 26.1% for the corresponding nine-month period of fiscal year 2010. Such as explained in the quarterly reports of the first two quarters of the current fiscal year, this marked increase in gross margin is due to sustained recurring revenues (services and consumables) and to the large proportion of industrial projects in the Company's revenue mix. Revenue composition (equipment versus services and consumables), diversity in applications (drinking water, wastewater treatment, water recycling), balancing of our clients (municipal versus industrial) and their geographical situation are key factors that directly impact the Company's gross margin. Simultaneously, our engineering, project management, and sourcing teams continue to improve their work processes so as to boost profitability for new projects. A better control of our budget related to project execution helps us improve gross margin.

The following table summarizes the evolution of our revenues and new orders, together with the variations in our backlog during the last seven quarters. Backlog growth over the last seven quarters is attributed to commercial activity related to the growing sales of equipment and systems and to the addition of our Indian joint-venture's contribution (mainly noticeable from the third quarter of the current fiscal year). The analysis of the ratio of new orders on revenues from sales of equipment and systems indicates a possible increase in our sales figure for next quarters.

	FY 2010				**FY 2011**		
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**
Backlog	$13.4 M*	$9.8 M	$14.5 M	$14.7 M	$14.3 M	$15.1 M	$22.9 M
Major orders for equipment and systems	$2.7 M	$4.2 M	$5.8 M	$6.7 M	$3.7 M	$7.4 M	$7.8 M
Revenues from sales of equipment and systems	$6.1 M	$4.7 M	$3.6 M	$3.1 M	$3.5 M	$3.6 M	$4.5 M
Orders / Revenues Ratio	***0.4***	***0.9***	***1.6***	***2.2***	***1.2***	***2.1***	***1.7***
Revenues from sales of services and consumables	$2.3 M	$2.4 M	$2.7 M	$2.8 M	$2.8 M	$2.8 M	$3.4 M
Total revenues	$8.4 M	$7.1 M	$6.3 M	$5.9 M	$6.3 M	$6.4 M	$7.9 M

* After cancellation of a $9.4 M contract from PCOSI

Operating expenses

At $2.1 M, the level of our selling, general and administrative ("SG&A") expenses was down by approximately $298,000 compared to the corresponding quarter of the previous fiscal year. The nine-month period ended March 31, 2011 shows a reduction of more than $615,000 of the Company's SG&A expenses, compared to the nine-month period of the 2010 fiscal year. This reduction, together with increased efficiencies, positively contributed to the increase in gross margin and shows how we have successfully implemented the cost reduction program announced in May 2010, without impacting our growth vectors. The SG&A expenses for the three-month period ended March 31, 2011 include $62,000 related to the operating expenses of our Indian joint-venture H_2O Innovation India Ltd.

For the three-month periods ended March 31, 2010 and 2011 respectively, the depreciation of fixed assets increased from $51,084 to $79,006. This increase can be mainly explained by the new upgrades to the production facilities at our PWT plant in California for the production of specialty chemicals. These upgrades, which were substantially completed during the first quarter of fiscal 2011, significantly increase our productivity and efficiency while insuring safer production operations. Over a nine-month period, this same depreciation increased from $193,260 to $231,466 respectively for the periods ended March 31, 2010 and 2011.

Moreover, the decrease in the depreciation of intangible assets for this third quarter decreased from $346,717 as at March 31, 2010 to $268,038 as at March 31, 2011. For the nine-month periods ended March 31, 2010 and 2011 respectively, the depreciation of intangible assets also decreased, from $1,062,687 to $806,998. This decrease compared to the previous fiscal years, for the three- and nine-month periods, is primarily due to the impact of the $1.8 M impairment of intangible assets recorded in the fourth quarter of the fiscal year ended June 30, 2010.

To date, Management is not aware of any factor or sign possibly affecting the value of the intangible assets or the recoverability of goodwill.

EBITDA

EBITDA[2] for the third quarter ended March 31, 2011 reached $390,901, compared to ($980,271) (including the effects of a mostly unrealized foreign exchange loss of $156,139) for the corresponding quarter ended March 31, 2010. Over the nine-month periods ended March 31, 2011 and 2010 respectively, EBITDA was $289,534 and ($2,035,663) (including the effects of a mostly unrealized foreign exchange loss of $913,742). Excluding share-based compensation, considered as a non-cash charge, adjusted EBIDTA was $496,075 and ($1,064,460) respectively for the nine-month periods ended March 31, 2011 and 2010. These encouraging results reflect the efforts made throughout the organization to increase sales, to adequately manage project execution, and to control fixed costs. With EBITDA amounting to 4.9% of the quarter's revenues, the strength of the Company's business model and its growth potential over the next fiscal years are clearly identified. EBITDA growth over the next quarters remains a priority for Management.

Other income and expenses

The reclassification of the Company's foreign operations from integrated to self-sustaining has for effect to eliminate unrealized exchange losses and leaves only a realized exchange loss of $38,487 as at March 31, 2011 compared to a mostly unrealized exchange loss of $156,139 as at March 31, 2010.

The interest expenses on long-term debt decreased from $211,974 to $148,751 respectively for the three-month periods ended March 31, 2010 and 2011. Over the nine-month periods ended March 31, 2010 and 2011, these same expenses decreased from $598,742 to $482,446 respectively. The decrease of more than 30 % on a quarterly basis and of over 19% over a nine-month period can mainly be explained by the repayments of principal on our long-term debt, amounting to $162,516 for the third quarter and $503,597 for the first nine months of the current fiscal year.

Net loss

During the quarter, the Company recorded a net loss of ($153,575) or ($0.003 per share), much lower than the net loss of ($1,558,567) or ($0.028 per share) recorded for the third quarter of fiscal 2010. Net loss for the nine-month period ended March 31, 2011 was ($1,345,398) or ($0.022 per share), down compared to ($3,777,477) or ($0.068 per share) for the corresponding nine-month period ended March 31, 2010.

In spite of a result that remains slightly negative, the increase in sales figure (amounting to $1,638,238) compared to the corresponding quarter of the previous fiscal year resulted in a major decrease in net loss for the three- and nine-month periods ended March 31, 2011, supported by an improvement in gross margin, a reduction in operating expenses level, a decrease in the depreciation of intangible assets following the impairment recorded in June 2010, a decrease in interests paid on long-term debts, and a lesser impact of foreign exchange fluctuations.

Commitments

The Company has entered into long-term lease agreements expiring in 2012, 2013 and 2017, which call for lease payments of $1,619,834 for the rental of space. The minimum annual lease payments over the next five years are $453,795 in 2011, $372,259 in 2012, $200,910 in 2013, $177,668 in 2014 and $186,374 in 2015.

[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.

Information on share capital

As at December 31, 2011, the Company had 60,145,832 outstanding shares. During this third quarter, no share was issued.

During the first nine months of fiscal 2011, the Company granted 2,035,000 stock options to its Board members and key personnel, the whole pursuant to the terms and conditions of the Company's stock option plan. These grants aim at implementing a profit sharing and compensation plan to retain personnel and provide an incentive to participate in the long-term development of the Company and the growth of shareholder value. The stock options entitle their holders to acquire one common share of the Company at a price of $0.50 before the end of September or November 2020 and have vesting periods from two to four years.

FINANCIAL SITUATION

After the change in operating working capital, **operating activities** for the third quarter ended March 31, 2011 generated $93,065 in cash, in comparison with $795,107 for the corresponding period ended March 31, 2010. For the nine-month periods ended March 31, 2011 and 2010, the Company used respectively $2,628,840 and $2,787,161 in cash. Cash generated by operating activities during this third quarter is mainly attributable to the increase of our operating activities and the significant decrease in our net loss as at March 31, 2011.

For this third quarter, **investing activities** required net cash of $344,414, mainly attributable to payments relating to contingent considerations as part of previous acquisitions amounting to $250,350.

Financing activities used net cash of $433,694 during the third quarter of fiscal 2011, compared to $213,416 of cash used during the corresponding period ended March 31, 2010.

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)

(in dollars, except per share data)

	Three-month periods ended			
	March 31, 2011	December 31, 2010	September 30, 2010	June 30, 2010
Revenues	7,950,587	6,421,506	6,339,866	5,921,355
EBITDA	390,901	(19,376)	(81,991)	(785,178)
Net earnings (Net loss)	(153,575)	(544,417)	(647,406)	(6,220,440)
EPS basic and diluted	(0.003)	(0.009)	(0.011)	(0.113)

	Three-month periods ended			
	March 31, 2010	December 31, 2009	September 30, 2009	June 30, 2009
Revenues	6,312,349	7,087,242	8,406,610	7,322,452
EBITDA	(980,271)	(982,737)	(72,860)	(1,301,902)
Net earnings (Net loss)	(1,558,567)	(1,576,222)	(642,688)	(1,067,448)
EPS basic and diluted	(0.028)	(0.029)	(0.012)	(0.022)

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.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Companyqs critical accounting policies have been the same since June 30, 2010, except for the translation of the Companyqs foreign operations. For a comprehensive description of our critical accounting policies and estimates, please refer to our consolidated financial statements as at and for the year ended June 30, 2010.

ACCOUNTING CHANGE

In its interim financial statements for quarters ended September 30, 2010 and December 31, 2010, management had reflected its foreign operations as integrated. During the third quarter of fiscal 2011 it completed a detailed analysis which identified significant changes in the economic facts and circumstances. The information obtained from the analysis states that the significant changes arose during the first quarter of fiscal 2011. In consequence, this analysis requires that the translation method applied to the foreign operations be changed. These significant facts and circumstances include a cost reduction program, merger of offices and a reorganization of the legal and operational structure, which lead to a significant degree of autonomy of the Companyqs foreign operations. Therefore, the foreign operations have been reclassified from integrated to self-sustaining.

The financial statements of the Companyqs foreign subsidiaries and joint-venture considered as self-sustaining operations are now translated using the current rate method. Under this method, assets and liabilities are translated into Canadian dollars at the exchange rate prevailing at the balance sheet date, and earnings items are translated into Canadian dollars at the average exchange rate for the period. Translation adjustments arising from exchange rate fluctuations are shown as %Accumulated other comprehensive loss+ under Shareholdersq equity. The translation of Canadian corporations remains unchanged.

The adjustments resulting from the translation of the Companyqs foreign subsidiaries and joint-venture are recorded under the caption %Accumulated other comprehensive loss+. This modification has been applied prospectively from July 1, 2010. The interim financial statements for the quarters ended September 30, 2010 and December 31, 2010 have been amended accordingly and re-filed and contain additional information on the effects of this accounting change.

The following tables present most significant changes to the financial statements of the quarters ended September 30, 2010 and December 31, 2010:

First quarter ended September 30, 2010 - Impact on Consolidated balance sheet	
ASSETS	
Decrease of long term assets	($381,190)
SHAREHOLDERSqEQUITY	
Decrease of deficit	($182,207)
Increase of accumulated other comprehensive loss	$563,397
Net impact	$381,190

First quarter ended September 30, 2010 - Impact on Consolidated statement of earnings	
EXPENSES	
Decrease of expenses	$52,193
Decrease of unrealized exchange loss	$129,294
Decrease of net loss	$182,207

Second quarter ended December 31, 2010 - Impact on Consolidated balance sheet	
ASSETS	
Decrease of long term assets	($1,046,532)
SHAREHOLDERSqEQUITY	
Decrease of deficit	($289,495)
Increase of accumulated other comprehensive loss	$1,373,128
Net impact	$1,046,532

Second quarter ended December 31, 2010 - Impact on Consolidated statement of earnings (3 month-period)	
EXPENSES	
Decrease of expenses	$14,674
Decrease of unrealized exchange loss	$92,614
Decrease of net loss	$107,288

Second quarter ended December 31, 2010 - Impact on Consolidated statement of earnings (6 month-period)	
EXPENSES	
Decrease of expenses	$67,587
Decrease of unrealized exchange loss	$221,908
Decrease of net loss	$289,495

The accounting change had a neutral effect on the Company¢s consolidated statements of cash flows for the quarters ended September 30, 2010 and December 31, 2010.

For a complete description of the changes to the financial statements of the quarters ended September 30, 2010 and December 31, 2010, please refer to Note 2 of the corresponding restated consolidated financial statements re-filed on May 12, 2011.

NEW ACCOUNTING STANDARDS

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. 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 has been 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.

IFRS 1 Ë First-time adoption of international reporting standards

Accounting policy developments
Transition to International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB)

The discussion in this section includes expectations at the reporting date about the transition from Canadian GAAP to IFRS as issued by the IASB, or IFRS-IASB (subsequently referred to as IFRS).

Key dates

- ✓ July 1, 2010 (transition date): An opening statement of financial position according to IFRS will be prepared, as at this date, to facilitate the changeover to IFRS in 2011. H_2O Innovation will continue to report its fiscal 2011 and comparative 2010 results according to the Canadian GAAP.
- ✓ July 1, 2011 (changeover date): The date after which H_2O Innovation will prepare and report interim and annual 2012 financial statements with 2011 comparatives according to IFRS.

Transition date impacts and policy choices

The transition to IFRS requires the Company to apply IFRS 1, or other requirements for preparing IFRS-compliant financial statements in the first reporting period after the changeover date. IFRS 1 applies only at the time of changeover, and includes a requirement for retrospective application of each IFRS, as if they were always in effect. IFRS 1 also mandates certain exceptions to retrospective application and provides a series of optional exemptions from retrospective application to ease the transition to the full set of IFRS. The Company discloses its initial decisions regarding transition date impacts in the table below. In addition, the Company determined a modest number of areas where changes in accounting policies were expected that may impact the consolidated financial statements.

			Unaudited pro forma effect on Net income
		Unaudited pro forma effect on Shareholders' Equity	
Policy area	**Choices and impacts net of income taxes** (in thousands of dollars . increase (decrease))	As at July 1, 2010	Nine-month period ended March 31, 2011
Past business combinations	**IFRS 1 optional exemption and transition date impact**: The Company currently expects not to restate its past business combinations that occurred before July 1, 2010 **Ongoing impact**: The Company had contingent considerations related to past business combinations which were not recognized under the Canadian GAAP. The Company has evaluated the liability in relation to those contingent considerations as of July 1, 2010. As at July 1, 2010 Other short-term liabilities 819 Other long-term liabilities 1,438 Retained earnings (2,257) Nine-month period ended March 31, 2011 Other short-term liabilities - Other expenses -	(2,257)	-
Fair value of property, plant and equipment and intangible assets as deemed cost	**IFRS 1 optional exemption and transition date impact**: The Company currently expects to use the carrying value at the date of transition to the exception of the building and land for which a valuation expertise was performed. **Ongoing impact**: The Company currently expects to use the cost model for each class of assets to the exception of the building and land for which the fair value at transition date has been chosen resulting in a decrease of the net book value to reflect fair value. As at July 1, 2010 Property, plant and equipment (250) Retained earnings (250) Nine-month period ended March 31, 2011 Depreciation	(250)	(7)
Share-based payment transactions	**IFRS 1 optional exemption and transition date impact**: The Company currently expects to use the exemption that allows first-time adopters not to apply IFRS 2 for equity settled share-based payments granted on or before November 2, 2002 and the exemption that allows first-time adopters not to apply IFRS 2 to share-based payments granted after November 7, 2002 that vested before the transition date.		

			Unaudited pro forma effect on Net income
		Unaudited pro forma effect on Shareholders' Equity	
Policy area	**Choices and impacts net of income taxes** (in thousands of dollars – increase (decrease))	As at July 1, 2010	Nine-month period ended March 31, 2011
Share-based payment transactions	**Ongoing impact**: The Company does not anticipate any significant impact for the forfeiture rate on stock options that have not vested before the transition date.	-	-
Designation of previously recognised financial instruments	**IFRS 1 optional exemption and transition date impact**: The Company currently expects not to reclassify a financial asset, other than an asset that meets the definition of "held for trading" as an "available-for-sale" financial asset as of July 1, 2010. **Ongoing impact**: The Company does not anticipate any further impact.	-	-
Cumulative translation adjustment	**IFRS 1 optional exemption and transition date impact**: The Company has elected to use the exemption under which the cumulative translation differences for all foreign operations are deemed to be zero at the date of transition. **Ongoing impact**: The Company does not anticipate any further impact since it does not intend to dispose of its foreign operations.	-	-
Joint ventures	IFRS currently provides a choice between using proportionate consolidation and the equity method while Canadian GAAP requires accounting for all interests in joint ventures within its scope using proportionate consolidation. **Transition date impact**: H_2O Innovation will elect to use the equity method to account for its Indian joint venture. This election will eliminate a difference that would have arisen upon the application of the new expected Standard that will be published in 2011, which would eliminate the choice for proportionate consolidation. As at July 1, 2010 Short-term assets (91) Long-term assets 82 Short-term liabilities (9) The presentation of the income statement will be different but there will be is no impact on net loss.	-	-
	As at March 31, 2011 Short-term assets (698) Long-term assets 114 Short-term liabilities (584) The presentation of the income statement will be different but there will be is no impact on net loss.	-	-
Property, plant and equipment	IFRS requires that parts of an item be depreciated separately, each over the length of its useful life. Management performed an analysis of the Company's property, plant and equipment and concluded that the building had significant parts such as the roof that has a specific useful life shorter than the remaining of the building following the valuation performed under IFRS 1. Management will consider this difference when it calculates the depreciation expense. Also, the Company has reviewed its depreciation methods for assets and their estimated useful lives. Determination of the financial impact of these changes is as follows:		

			Unaudited pro forma effect on Net income
		Unaudited pro forma effect on Shareholders' Equity	
Policy area	**Choices and impacts net of income taxes** (in thousands of dollars – increase (decrease))	As at July 1, 2010	Nine-month period ended March 31, 2011
Property, plant and equipment	As at July 1, 2010 There is no impact on the opening balances of items of property, plant and equipment following the review made over depreciation methods and estimated useful lives except as indicated above under IFRS 1. Nine-month period ended March 31, 2011 Depreciation	-	(3)
	Total effects	(2,507)	(10)

OFF-BALANCE SHEET ARRANGEMENTS

As at March 31, 2011, 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 is secured by a certificate of deposit. The balance, amounting to $0.26 M, was guaranteed by *Export Development Canada*.

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 Director of Finance ("Director of Finance") 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 Director of Finance 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 Director of Finance, of the effectiveness of our disclosure controls and procedures. Based on this evaluation, the CEO and the Director of Finance concluded that the disclosure controls and procedures are effective.

Internal controls over financial reporting

The CEO and the Director of Finance 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 Director of Finance, of the design and effectiveness of our internal controls over financial reporting. Based on this evaluation, the CEO and the Director of Finance 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

During the quarter, the Company did not make any modifications to the internal controls over financial reporting that had or could reasonably be expected to have a significant impact on the internal controls over financial reporting.

Consolidated Financial Statements

Quarterly Report
March 31, 2011

These interim consolidated financial statements have not been subjected to an audit or to a review engagement by the auditors.

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 at *www.h2oinnovation.com* and on SEDAR

H_2O INNOVATION INC.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	As at March 31, 2011	As at June 30, 2010
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	**412,320**	2,672,375
Held-for-trading investments	**1,493,674**	1,266,751
Held-to-maturity investments	**-**	39,908
Accounts receivable	**7,801,096**	4,857,285
Inventories	**2,861,792**	1,915,107
Work in process	**1,736,898**	2,148,946
Prepaid expenses	**482,905**	308,263
	14,788,685	13,208,635
Fixed assets	**2,375,859**	2,451,115
Intangible assets	**8,647,229**	10,313,821
Other assets	**42,058**	44,141
Goodwill	**10,235,376**	10,901,443
Future income tax assets	**6,597**	6,597
	36,095,804	36,925,752
LIABILITIES		
Current liabilities		
Bank loan	**2,267,993**	-
Accounts payable and accrued liabilities	**3,862,769**	4,815,253
Billings in excess of work in process	**1,347,801**	233,537
Current portion of long-term debt	**628,985**	619,768
Current portion of convertible debenture (Note 5)	**750,000**	-
	8,857,548	5,668,558
Long-term debt	**1,261,058**	1,569,200
Convertible debenture (Note 5)	**702,184**	1,354,530
Deferred rent	**42,602**	56,938
	10,863,392	8,649,226
SHAREHOLDERS' EQUITY		
Equity component of convertible debenture (Note 5)	**301,023**	301,023
Capital stock (Note 6)	**45,866,225**	45,858,645
Contributed surplus	**11,655,016**	11,453,475
Deficit	**(30,682,015)**	(29,336,617)
Accumulated other comprehensive loss	**(1,907,837)**	-
	25,232,412	28,276,526
	36,095,804	36,925,752

The 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

H_2O INNOVATION INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

	Common shares Number	Share capital $	Equity component of convertible debenture $	Contributed surplus $	Deficit $	Accumulated other comprehensive loss $	Total $
Balance as at June 30, 2009	**55,146,843**	**43,778,820**	**301,023**	**11,375,483**	**(19,338,700)**	**-**	**36,116,626**
Stock-based compensation costs	-	-	-	57,461	-	-	57,461
Fair value of stock options exercised	16,667	8,667	-	(3,333)	-	-	5,334
Net loss for the period	-	-	-	-	(3,777,477)	-	(3,777,477)
Balance as at March 31, 2010	**55,163,510**	**43,787,487**	**301,023**	**11,429,611**	**(23,116,177)**	**-**	**32,401,944**
Balance as at June 30, 2010	**60,127,727**	**45,858,645**	**301,023**	**11,453,475**	**(29,336,617)**	**-**	**28,276,526**
Share issue expenses related to private financing (note 6)	-	(5,420)	-	-	-	-	(5,420)
Fair value of stock options exercised	25,000	13,000	-	(5,000)	-	-	8,000
Other comprehensive loss	-	-	-	-	-	(1,907,837)	(1,907,837)
Stock-based compensation costs	-	-	-	206,541	-	-	206,541
Net loss for the period	-	-	-	-	(1,345,398)	-	(1,345,398)
Balance as at March 31, 2011	**60,152,727**	**45,866,225**	**301,023**	**11,479,239**	**(30,682,015)**	**(1,907,837)**	**25,232,412**

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

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(Unaudited)

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2011	2010	**2011**	2010
	$	$	**$**	$
Net loss for the period	**(153,575)**	(1,558,567)	**(1,345,398)**	(3,777,477)
Other comprehensive loss				
Translation adjustment	**(545,550)**	-	**(1,907,837)**	-
Comprehensive loss for the period	**(699,125)**	(1,558,567)	**(3,252,235)**	(3,777,477)

CONSOLIDATED STATEMENTS OF COMPONENTS OF ACCUMULATED OTHER COMPREHENSIVE LOSS

(Unaudited)

As at March 31,	**2011**	2010
	$	$
Translation adjustment	**(1,907,837)**	-
Accumulated other comprehensive loss	**(1,907,837)**	-

The total of Accumulated Other Comprehensive Loss and Deficit as at March 31, 2011 is $32,589,852 ($23,116,177 as at March 31, 2010).

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

H_2O INNOVATION INC.

CONSOLIDATED STATEMENT OF EARNINGS

(Unaudited)

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2011	2010	**2011**	2010
	$	$	**$**	$
Sales	**7,950,587**	6,312,349	**20,711,959**	21,806,201
Cost of goods sold	**5,324,654**	4,709,287	**14,175,352**	16,125,560
Gross margin	**2,625,933**	1,603,062	**6,536,607**	5,680,641
Expenses				
Operating, selling, administrative and general expenses	**2,122,272**	2,420,690	**6,080,590**	6,695,877
Depreciation of fixed assets	**79,006**	51,084	**231,466**	193,260
Amortization of intangible assets	**268,038**	346,717	**806,998**	1,062,687
Bank charges and other financial expenses	**40,969**	41,961	**106,310**	107,447
Government assistance	**(2,068)**	(18,775)	**(50,831)**	(93,275)
Stock-based compensation	**95,869**	30,924	**206,541**	57,461
	2,604,086	2,872,601	**7,381,074**	8,023,457
Operating earnings (loss) before the following items	**21,847**	(1,269,539)	**(844,467)**	(2,342,816)
Other income	**(36,407)**	(8,049)	**(50,396)**	(25,371)
Exchange loss	**38,487**	156,139	**34,162**	913,742
Interest on long-term debt	**148,751**	211,974	**482,446**	598,742
Loss on disposal of fixed assets	**-**	2,404	**-**	125,083
Loss on disposal of intangible assets	**-**	-	**-**	15,955
Acquisition and integration expenses	**16,879**	-	**27,007**	27,038
	167,710	362,468	**493,219**	1,654,983
Loss before income taxes	**(145,863)**	(1,632,007)	**(1,337,686)**	(3,997,799)
Income taxes				
Current income taxes	**7,712**	-	**7,712**	-
Future income taxes	**-**	(73,440)	**-**	(220,322)
	7,712	(73,440)	**7,712**	(220,322)
Net loss for the period	**(153,575)**	(1,558,567)	**(1,345,398)**	(3,777,477)
Basic and diluted net loss per share	**(0.003)**	(0.028)	**(0.022)**	(0.068)
Weighted average number of shares outstanding (Note 7)	**60,145,832**	55,149,207	**60,141,087**	55,142,989

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

H_2O INNOVATION INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2011	2010	**2011**	2010
	$	$	**$**	$
Cash flows from operating activities				
Net loss for the period	**(153,575)**	(1,558,567)	**(1,345,398)**	(3,777,477)
Non-cash items				
Change in fair value of held-for-trading investments	**-**	3,506	**-**	4,947
Interest capitalized on held-to-maturity investment	**-**	(455)	**-**	(1,338)
Exchange loss on held-to-maturity investment	**-**	1,218	**-**	5,623
Depreciation of fixed assets	**79,006**	51,084	**231,466**	193,260
Amortization of intangible assets	**268,038**	346,717	**806,998**	1,062,687
Loss on disposal of fixed assets	**-**	2,404	**-**	125,083
Loss on disposal of intangible assets	**-**	-	**-**	15,955
Stock-based compensation	**95,869**	30,924	**206,541**	57,461
Deferred rent	**(3,135)**	-	**(9,663)**	-
Future income taxes	**-**	(73,440)	**-**	(220,322)
Unrealized exchange gain on long-term debt	**-**	(11,964)	**-**	(56,255)
Imputed interest on long-term debt and convertible debenture	**79,253**	61,697	**182,409**	184,889
	365,456	(1,146,876)	**72,353**	(2,405,487)
Net change in non cash working capital items (Note 8)	**(272,391)**	1,941,983	**(2,701,193)**	(381,674)
	93,065	795,107	**(2,628,840)**	(2,787,161)
Cash flows from investing activities				
Disposal of held-for-trading investments	**-**	-	**39,298**	-
Acquisition of held-for-trading investments	**(81,158)**	-	**(228,268)**	-
Acquisition of fixed assets	**(10,132)**	(45,271)	**(192,653)**	(330,292)
Acquisition of intangible assets	**(2,774)**	(5,976)	**(12,517)**	(70,729)
Proceeds from disposal of fixed assets	**-**	-	**-**	127,545
Proceeds from disposal of intangible assets	**-**	-	**-**	45,000
Business acquisitions (Note 3)	**(250,350)**	-	**(1,088,591)**	-
Other assets	**-**	824	**-**	3,924
	(344,414)	(50,423)	**(1,482,731)**	(224,552)
Cash flows from financing activities				
Variation of bank loan	**596,210**	-	**2,271,961**	-
Long-term debt reimbursement	**(162,516)**	(218,750)	**(503,597)**	(656,250)
Long-term debt contracted	**-**	-	**124,692**	-
Issuance of shares	**-**	5,334	**8,000**	5,334
Share issue expenses	**-**	-	**(5,420)**	-
	433,694	(213,416)	**1,895,636**	(650,916)
Net change in cash	**182,345**	531,268	**(2,215,935)**	(3,662,629)
Effect of exchange rate changes on cash and cash equivalents	**(14,694)**	-	(44,119)	-
Increase (Decrease) in cash and cash equivalents	**167,651**	531,268	(2,260,054)	(3,662,629)
Cash and cash equivalents - Beginning of period	**244,670**	1,400,509	**2,672,375**	5,594,406
Cash and cash equivalents - End of period	**412,321**	1,931,777	**412,321**	1,931,777

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ACCOUNTING CHANGES

The unaudited interim consolidated financial statements of the Company for the nine-month periods ended March 31, 2011 and 2010 have been prepared in accordance with Canadian generally accepted accounting principles (%GAAP+) and should be read in conjunction with the 2010 audited annual consolidated financial statements. The accounting policies are the same as those used for the 2010 audited annual consolidated financial statements except for the translation of the Companyqs foreign operations.

In its interim financial statements for quarters ended September 30, 2010 and December 31, 2010, management had reflected its foreign operations as integrated. During the third quarter of fiscal 2011 it completed a detailed analysis which identified significant changes in the economic facts and circumstances. The information obtained from the analysis states that the significant changes arose during the first quarter of fiscal 2011. In consequence, this analysis requires that the translation method applied to the foreign operations be changed. These significant facts and circumstances include a cost reduction program, merger of offices and a reorganization of the legal and operational structure, which lead to a significant degree of autonomy of the Companyqs foreign operations. Therefore, the foreign operations have been reclassified from integrated to self-sustaining. The restated interim financial statements for quarters ended September 30, 2010 and December 31, 2010 have been re-filed on May 12, 2011.

The financial statements of foreign subsidiaries and of the joint venture considered as self-sustaining operations are translated using the current rate method. Under this method, assets and liabilities are translated in Canadian dollars at the exchange rate prevailing at the balance sheet date, and earnings items are translated in Canadian dollars at the average exchange rate for the period. Translation adjustments arising from exchange rate fluctuations are shown as %Accumulated other comprehensive loss+ under Shareholdersq equity. The translation of Canadian corporations remains unchanged.

The adjustments resulting from the translation of the Companyqs foreign subsidiaries and joint venture are recorded under the caption %Accumulated other comprehensive loss+. This modification has been applied prospectively from July 1, 2010.

2. FUTURE ACCOUNTING CHANGES

On February 13, 2008, the Accounting Standards Board confirmed the date of changeover from Canadian GAAP to International Financial Reporting Standards (IFRS). Canadian publicly accountable enterprises must adopt IFRS for their interim and annual financial statements relating to fiscal periods beginning on or after January 1, 2011. The Company has developed an IFRS transition plan for the conversion of its consolidated financial statements to IFRS. An analysis of the differences between IFRS and the Companyqs accounting standards is underway. This analysis is being conducted by taking into account the potential impacts, among others, on accounting policies, financial reporting and information technologies. To date, the Company is unable to show the consequences of the conversion from Canadian GAAP to IFRS on its financial statements.

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

a) Section 1582, %Business Combinations+, which replaces the former Section 1581 of the same name, establishes accounting 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 of the same name, establishes standards for the preparation of consolidated financial statements.

c) Section 1602, %Non-Controlling Interests+. This new section establishes standards for accounting for a non-controlling interest 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 currently evaluating the impact of these new standards on its financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

3. BUSINESS ACQUISITIONS

a) During the previous year, the Company recorded a provision of $564,049 (US$529,822) as earn-out payment related to the acquisition of Professional Water Technologies which was captured as goodwill and the counterpart was included in accounts payable and accrued liabilities. During the nine-month period, an amount of $531,791 (US$529,822) was paid in relation with this acquisition.

b) During the previous year, the Company recorded a provision of $779,830 (US$732,510) as earn-out payment related to the acquisition of Membrane Systems Inc. which was captured as goodwill and the counterpart was included in accounts payable and accrued liabilities. During the nine-month period, an amount of $556,800 (US$550,000) was paid in relation with this acquisition (during the quarter, an amount of $250,350 (US$250,000) was paid in relation with this acquisition) and the remaining balance is included in accounts payable and accrued liabilities.

c) During the previous 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 accounts payable and accrued liabilities and the counterpart is recorded as goodwill.

4. INTEREST IN A JOINT VENTURE

In February 2010, the Company became 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, expenses and cash flows of the joint venture, which is included in these consolidated financial statements:

	Nine-month period ended March 31, 2011	Four-month period ended June 30, 2010
	$	$
Earnings		
Revenues	**821,965**	14,711
Expenses	**782,517**	37,762
Net earnings (loss)	**39,448**	(23,051)

	As at March 31, 2011	As at June 30, 2010
	$	$
Cash flows		
Change in working capital items	**(236,589)**	4,637
Acquisition of fixed assets	**(8,094)**	(3,764)
Balance sheet		
Current assets	**697,957**	90,830
Long-term assets	**9,573**	3,764
Current liabilities	**584,328**	9,139

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

5. CONVERTIBLE DEBENTURE

	As at March 31, 2011	As at June 30, 2010
	$	$
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	**267,880**	177,562
Amortization of financing expenses	**38,990**	31,654
	1,452,184	1,354,530
Less: Current portion of convertible debenture	**(750,000)**	-
Convertible debenture	**702,184**	1,354,530

(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.

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% (effective rate of 19.1%) as from July 9, 2010. The other debenture terms remain unchanged.

The new terms of the debenture are not substantially different from the previous ones and in consequence, this operation is considered as the continuity of the original financial liability. The revised effective interest rate is 19.1%.

6. CAPITAL STOCK

Authorized

Unlimited number of common shares, without par value

As at March 31, 2011	**Number of shares**	**Amount**
		$
Issued and paid at the beginning of period	**60,120,832**	**45,844,856**
Share issue expenses related to private financing (i)	**-**	**(5,420)**
Shares issued on exercise of options	**25,000**	**13,000**
	60,145,832	**45,852,436**
Shares to be issued		
In settlement of business acquisition	**6,895**	**13,789**
Balance - End of period	**60,152,727**	**45,866,225**

As at June 30, 2010	Number of shares	Amount
		$
Issued and paid at the beginning of period	55,139,948	43,765,031
Shares issued in connection with private financing (ii)	4,955,884	2,066,825
Shares issued on exercise of options	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 period	60,127,727	45,858,645

(i) During the period, share issue expenses related to private financing in the previous year amounted to $5,420 have been reflected in capital stock.

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

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 is 5,500,000.

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

Six-month period ended March 31	**2011**
Number of stock options	2,035,000
Expected dividend yield	0%
Expected volatility	70%
Risk-free interest rate	From 2.87% to 3.21%
Weighted average expected life (years)	10
Weighted average fair value at the grant date	$0.25

6. CAPITAL STOCK (CONTINUED)

Stock-Based Compensation Plan (Continued)

For the nine-month period ended March 31, 2011, the Company recorded $206,541 ($57,461 in 2010) 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 March 31, 2011 and June 30, 2010 and the change during the periods ended on these dates:

	Nine-month period ended March 31, 2011		Twelve-month period ended June 30, 2010	
	Number	**Weighted average exercise price**	Number	Weighted average exercise price
		$		$
Outstanding - Beginning of period	**1,950,000**	**1.11**	1,815,000	1.15
Granted	**2,035,000**	**0.50**	205,000	0.75
Exercised	**(25,000)**	**0.32**	(25,000)	0.32
Forfeited	**-**	**-**	(45,000)	1.48
Outstanding - End of period	**3,960,000**	**0.80**	1,950,000	1.11
Exercisable - End of period	**1,827,500**	**1.14**	1,691,639	1.14

As at March 31, 2011, the following stock options were granted:

Exercise price	Holders	Number of shares	Weighted average remaining life (years)	Weighted average exercise price
$				$
0.32	Directors	125,000	2.69	0.32
0.50	Directors	290,000	9.62	0.50
0.75	Directors	225,000	8.75	0.75
0.90	Directors	262,000	2.24	0.90
1.20	Directors	260,000	0.77	1.20
1.50	Directors	324,500	1.39	1.50
0.50	Employees	1,725,000	9.48	0.50
0.90	Employees	270,000	2.24	0.90
1.20	Employees	125,000	0.77	1.20
1.50	Employees	333,500	1.39	1.50
1.85	Employees	20,000	1.16	1.85
		3,960,000	6.03	0.80

6. CAPITAL STOCK (CONTINUED)

Stock-Based Compensation Plan (Continued)

As at March 31, 2011, the following stock options could be exercised:

Exercise price	Number of shares	Weighted average exercise price
$		$
0.32	125,000	0.32
0.75	107,500	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
	1,827,500	1.14

Warrants

In the course of its financing transactions, the Company issued warrants to investors giving 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 March 31, 2011 and June 30, 2010 and the change during the periods ended on those dates are summarized in the following table:

	Nine-month period ended March 31, 2011		Twelve-month period ended June 30, 2010	
	Number	**Weighted average exercise price**	Number	**Weighted average exercise price**
		$		$
Outstanding - Beginning and end of period	**9,179,877**	**0.88**	9,179,877	0.88

As at March 31, 2011, 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	

7. 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:

	Three months ended March 31,		Nine months ended March 31,	
	2011	2010	**2011**	2010
Basic and diluted weighted average number of shares outstanding	**60,145,832**	55,149,207	**60,141,087**	55,142,989

For the periods ended March 31, 2011 and 2010, 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 anti-dilutive. Accordingly, the diluted loss per share for these periods is calculated using the weighted average basic 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 nil shares for the period ended March 31, 2011 (158,333 shares for the period ended March 31, 2010), to the weighted average number of shares outstanding used in the diluted earnings per share calculation.

8. CASH FLOWS

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

	Three months ended March 31,		Nine months ended March 31,	
	2011	2010	**2011**	2010
	$	$	**$**	$
Accounts receivable	**129,312**	2,568,250	**(3,292,744)**	4,289,358
Inventories	**(302,318)**	(5,589)	**(1,018,331)**	(103,887)
Work in process	**(379,667)**	(236,481)	**316,312**	(1,613,463)
Prepaid expenses	**(263,611)**	(354,845)	**(185,094)**	(308,296)
Accounts payable and accrued liabilities	**684,910**	(73,339)	**306,506**	(1,721,864)
Excess of billing over work in process	**(141,017)**	49,062	**1,172,158**	(904,113)
Deferred rent	**-**	(5,075)	**-**	(19,409)
	(272,391)	1,941,983	**(2,701,193)**	(381,674)

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

	As at March 31, 2011	As at June 30, 2010
	$	$
Acquisition of fixed assets included in accounts payable and accrued liabilities	**-**	11,643
Business acquisitions included in accounts payable and accrued liabilities	**112,638**	1,201,229

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

8. CASH FLOWS (CONTINUED)

c) Additional information

	Three months ended March 31,		Nine months ended March 31,	
	2011	2010	**2011**	2010
	$	$	**$**	$
Interest paid	**173,213**	203,818	**425,801**	436,007
Income taxes paid	**7,712**	-	**22,532**	-

9. 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
Richard Hoel, Director (1)
Lisa Henthorne, Director (2)
Laurence E. Gamst, Director (1)

(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.

Transfer Agent

Computershare Investor Services Inc.

Head Office

420, boul. Charest Est, Suite 240
Quebec City, Quebec, G1K 8M4
Phone: 418-688-0170
Fax: 418-688-9259

investor@h2oinnovation.com
www.h2oinnovation.com

Plants

201, 1st Avenue
Ham-Nord, Quebec G0P 1A0

1048 La Mirada Court
Vista, California 92081

6840 Shingle Creek Parkway, Suite 20
Brooklyn Center, Minnesota 55430

Sales and Engineering Offices

1046, 18th Ave SE
Calgary, Alberta T2G 1L6

H_2O Innovation India Ltd.
Chembond Center
EL-71, M.I.D.C., Mahape
Navi Mumbai - 400 710
Maharashtra . India