Interim financial report
First quarter ended
September 30, 2012

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

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 Innovation's results of operations and financial position for the quarter ended September 30, 2012, in comparison with the corresponding period ended September 30, 2011. They should be read in conjunction with the consolidated financial statements and accompanying notes. Comparison of financial situation as at September 30, 2012 to those as at June 30, 2012 is also included. Certain statements set forth in this Management's Discussion and Analysis ("MD&A") 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 words such as "anticipate", "if", "believe", "plan", "estimate", "expect", "intend", "may", "could", "should", "will", and other similar expressions, 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 25, 2012 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.

The following financial statements have been reviewed by our auditors, except for the corresponding figures that have not been reviewed by our auditors. They have been prepared in accordance with International Financial Reporting Standards ("IFRS"). All figures in the present report are expressed in Canadian dollars, unless otherwise indicated.

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

H_2O Innovation provides integrated technological water treatment solutions based on membrane filtration technology to municipal, energy & mining end-users. H_2O Innovation designs 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, while providing a complete line of specialty chemicals and consumables for membrane filtration and reverse osmosis systems. With more than 115 employees and seven locations in North America, H_2O Innovation is also a founding partner of H_2O Innovation India, a joint venture based in Mumbai, India.

NON-IFRS FINANCIAL MEASUREMENT

In this MD&A, the Company's management uses a measure that is not in accordance with IFRS. The measurement "Adjusted earnings before interest, tax depreciation and amortization (adjusted EBITDA)" is not defined by IFRS and cannot be formally presented in consolidated financial statements. The definition of adjusted EBITDA does not take into account the Company's changes in fair value of contingent considerations, impairment of intangible assets, impairment of goodwill, stock-based compensation costs and share of (earnings) loss in a joint venture. The reader can establish the link between adjusted EBITDA and net loss. The definition of adjusted EBITDA used by the Company may differ from those used by other companies.

Even though adjusted EBITDA is a non-IFRS measure, it is used by management, analysts, investors and other financial stakeholders to assess the Company's performance and management from a financial and operational standpoint.

Reconciliation of adjusted EBITDA to net earnings (loss)

Three-month periods ended September 30,	**2012**	2011
	$	$
Net earnings (loss) for the period	**269,696**	(88,216)
Finance costs – net	**205,119**	194,164
Income taxes	**-**	(177,188)
Depreciation of property, plant and equipment	**68,484**	77,003
Amortization of intangible assets	**177,758**	233,624
Stock-based compensation costs	**16,174**	52,588
Share of (earnings) loss in a joint venture	**(10,538)**	40,833
Adjusted EBITDA	**726,693**	332,808

RESULTS OF OPERATIONS

Selected financial data
(Unaudited)

	Three-month periods ended September 30, 2012	2011
	$	$
Revenues	**9,982,894**	7,069,768
Gross profit	**2,462,571**	1,744,081
Gross profit	**24.7%**	24.7%
Operating expenses	**135,772**	105,106
Selling expenses	**843,154**	864,667
Administrative expenses	**863,263**	855,092
Net earnings (loss)	**269,696**	(88,216)
Basic and diluted earnings (loss) per share	**0.004**	(0.001)
Adjusted EBITDA	**726,693**	332,808

Revenues and gross profit

Revenues for the first quarter of fiscal 2013 totaled $9.98 M, representing a $2.9 M or 41.2% increase, as compared with revenues of $7.1 M for the same quarter of fiscal 2012. The increase is largely attributable to revenues from projects which reached $7.0 M compared to $4.3 M in the corresponding period of the previous fiscal year, representing a 63.6% increase. More than half of that $7.0 M revenues come from three (3) projects in the oil & gas sector in Western Canada. This is a direct consequence of the materialisation of our order backlog which remained above the $20 M as at September 30, 2012.

The increase of revenues is also attributable to a lesser extent to revenues from sales of specialty chemicals and consumables which reached $2.9 M in this quarter compared with $2.8 M in 2012, representing a 6.4% increase. These revenues are recurring in nature. Continued efforts are being deployed to increase our footprint through the addition of new specialty chemical distributors. Moreover, we gave particular attention to maintain service contracts on our installed base while we continue to build relationships with clients of newly commissioned projects.

In this first quarter of fiscal 2013, the Company was able to generate a 24.7% gross profit, a level similar to the first quarter of fiscal year 2012. This is a significant improvement from the 19.4% gross profit realized in the fourth quarter of fiscal year 2012. This performance is partly attributable to the changes initiated and implemented since June 30, 2012 meant to enhance both project execution and manufacturing operations with the primary objective of increasing overall gross profit. The gross profit has also improved due to the increase of exportation of specialty chemicals during the first quarter of fiscal year 2013.

The Company also brought in a solid $6.7 M in new bookings for water treatment projects over the quarter. These new bookings kept the order backlog above the $20 M mark as at September 30, 2012. The Company's bookings over revenue ratio for projects was close to 1 at 0.9 for the quarter. This represents a significant improvement from the 0.2 bookings over revenues ratio realized a year ago. This is moreover significant since the level of revenues from water treatment projects have significantly increased, meaning that keeping a ratio nearly 1 is more challenging. The level of new bookings achieved in the first quarter of fiscal 2013 is in line with management's expectations for the current fiscal year.

The following table summarizes the evolution of the Company's revenues and new orders, together with the variations in its backlog over the last five quarters.

	2012 FY				2013 FY	**Last twelve months**	**Previous twelve months**
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**(Q2, Q3 & Q4 FY2012 & Q1 FY2013)**	(Q2, Q3 & Q4 FY2011 & Q1 FY2012)
Order backlog	$31.6 M	$30.0 M	$28.1 M	$20.8 M	$20.4 M	**N/A**	N/A
Bookings for water treatment projects	$0.9 M	$4.7 M	$6.0 M	$4.7 M	$6.7 M	**$22.1 M**	$33.5 M
Revenues from water treatment projects	$4.3 M	$4.1 M	$6.7 M	$7.6 M	$7.1 M	**$25.5 M**	$17.1 M
Bookings / Revenues Ratio	***0.2***	***1.1***	***0.9***	***0.6***	***0.9***	***0.87***	***1.96***
Revenues from specialty chemicals and consumables (usually recurrent in nature)	$2.8 M	$3.0 M	$3.5 M	$3.9 M	$2.9 M	**$13.3 M**	$12.2 M

Operating expenses

Showing an increase of approximately $30,000, operating expenses remained relatively stable at $0.1 M for this quarter compared to the corresponding quarter of previous fiscal. This slight increase is due to the hiring of an additional person to support the expedition of specialty chemicals and to traveling expenses to overview the assembly of a large project delivered during this quarter in Western Canada.

Selling expenses

Selling expenses have decreased by over $20,000 and remained relatively stable at $0.8 M for this quarter compared with the corresponding quarter of the previous fiscal year, despite revenues having increased by 41.2%. Selling expenses are linked to bookings and revenues, but do not fluctuate proportionally. The decrease is mostly due to the ending of consulting agreements over the last fiscal year.

Administrative expenses

Administrative expenses increased by approximately $8,000 or 1.0% in this first quarter of fiscal 2013 compared with the first quarter of fiscal 2012. Even though salaries and fringe benefits have decreased following the elimination of management positions in June 2012, the Company has encountered higher professional fees and office expenses during the period ended September 30, 2012 compared with the period ended September 30, 2011. Management does not expect this increase in professional fees to repeat until the end of fiscal 2013 since some are non recurring in nature.

The Company's ratio of selling, operating and administrative expenses ("SG&A") as a whole over revenues amounted to 18.4% for this quarter, down from 25.8% for the corresponding quarter of the previous fiscal year. This decrease is partially attributable to the increase in volume of business and reflects our efforts to reach profitability and maximize the use of our internal resources. Overall, the Company's SG&A expenses remain in line with its fiscal year 2013 budget.

Adjusted EBITDA

Adjusted EBITDA for the quarter was recorded at $726,693, compared with $332,808 for the same period ended September 30, 2011. The higher revenues recorded during the quarter compared with the corresponding quarter of the previous fiscal year and the somewhat stable SG&A expenses also contributed to generating solid positive adjusted EBITDA. The Company quickly and strongly returned to positive adjusted EBITDA this quarter after one quarter of negative adjusted EBITDA for the fourth quarter ended June 30, 2012.

Other gains – net

Other gains – net amounting to $82,271 for the period ended September 30, 2012 compared with $351,208 for the quarter ended September 30, 2011 are mostly composed of a foreign exchange gain, which is entirely due to exchange rate fluctuations related to working capital items.

Finance costs – net

Finance costs – net totalled $205,119 for the period ended September 30, 2012 compared to $225,807 for the comparable period in the previous fiscal year. These expenses relate mostly to the long-term debt. Of this amount, $29,710 represent the theoretical and non-monetary part of interest on long-term debt and $18,102 represent the unwinding of the discount on contingent considerations.

Share of earnings (loss) in a joint venture

Share of earnings (loss) in a joint venture totalled $10,538 for the period ended September 30, 2012 compared with a share of earnings (loss) of ($40,833) for the quarter ended September 30, 2011. These earnings are largely attributable to the entering of projects into the fabrication phase which is a higher revenue-generating phase.

Net earnings (loss)

The net earnings (loss) was $269,696 or $0.004 per share for the first quarter of fiscal 2013 compared with ($88,216) or ($0.001 per share) for the first quarter of fiscal 2012. This improvement is primarily due to higher revenues which generated a solid gross profit of 24.7%. Management has applied a tight control on project execution notably for procurement and on hours spent on projects. Moreover, SG&A are challenged continuously and additional savings are contemplated.

Commitments

The Company has entered into long-term lease agreements expiring in 2013, 2017 and 2022, which call for lease payments of $3,448,235 for the rental of space. The minimum annual lease payments over the next five years are $464,069 in 2013, $394,869 in 2014, $410,328 in 2015, $419,243 in 2016 and $428,384 in 2017.

Information on share capital

As at September 30, 2012, the Company had 60,145,832 outstanding shares. No share was issued during this quarter.

FINANCIAL SITUATION

Working capital increased from $2.5 M as at June 30, 2012 (current ratio of 1.19) to $2.7 M as at September 30, 2012 (current ratio of 1.22). The increase is attributable to the $1.3 M and $0.2 M decrease in accounts receivables and costs incurred in excess of billings respectively, the increase of $0.5 M in inventory, the decrease of $0.2 M and $0.3 M in accounts payable and accrued liabilities and billings in excess of costs incurred respectively and to the reimbursement of the short-term portion of the long-term debt.

The net debt excluding contingent considerations, which stood at $5.2 M as at September 30, 2012, decreased by nearly $1.0 M compared with $6.1 M as at June 30, 2012. This decrease is mainly attributable to the general improvement in working capital, itself caused by the delivery of important milestones in projects which were billed to clients and cashed during the quarter. The decrease is also caused by the reimbursement of long-term debt after the end of the moratorium exercised during fiscal year 2012.

Equity stood at $13.6 M as at September 30, 2012, compared with $13.7 M as at June 30, 2012. As at September 30, 2012 the net debt equity ratio was 0.38 whereas it was 0.45 as at June 30, 2012, showing that the Company is not over leveraged.

(in Canadian dollars, except for ratio)	**Period ended September 30, 2012**	**Period ended June 30, 2012**
Working capital	$2,726,770	$2,518,829
Current ratio	1.22	1.19
Net debt[1]	$5,173,242	$6,129,684
Equity	$13,586,291	$13,744,227
Net debt to equity ratio	0.38	0.45

[1] Net debt comprises bank overdraft, bank loans and the long-term debt, net of cash and cash equivalents, but excludes the contingent considerations.

As at September 30, 2012 accounts receivable stood at $8.0 M compared with $9.3 M as at June 30, 2012. The decrease of $1.3 M is attributable to the collection of amounts due by clients derived from high invoicing at the end of the fourth quarter of fiscal 2012. Part of the Company's trade account receivables is guaranteed by Export Development Canada.

Inventories increased by $0.5 M to $2.7 M as at September 30, 2012 compared with $2.2 M as at June 30, 2012. This increase is largely attributable to finished goods manufactured during the summer in preparation for the start of the maple syrup production season. Raw materials have lightly decreased by $0.1M due to better use of our in-hand or slow moving items.

Costs incurred in excess of billings decreased by $0.2 M to $1.9 M as at September 30, 2012, from $2.1 M as at June 30, 2012, primarily due to a similar number of active projects for which there are differences between project advancement and project invoicing schedules. Billings in excess of costs incurred decreased by $0.3 M to $1.3 M as at September 30, 2012, from $1.6 M as at June 30, 2012. This decrease is also attributable to differences between project advancement and project invoicing schedules.

Accounts payable and accrued liabilities decreased by $0.2 M to $5.5 M as at September 30, 2012, from $5.7 M as at June 30, 2012. This is mostly due to a similar number of active projects entering the production phase for which important components are being purchased since the second-half of fiscal year 2012.

The decrease in the current portion of the long-term debt, the balance of which fell from $2.6 M as at June 30, 2012 to $2.4 M as at September 30, 2012, is explained by the repayment of $0.3 M for the long-term debt.

Contingent considerations remained stable at $0.48 M as at September 30, 2012 and as at June 30, 2012. Of the $0.48 M total contingent considerations, an amount of $0.02 M is expected to be paid over the next 12 months, the balance of $0.46 M over a period stretching up to 2018.

For the first quarter ended September 30, 2012, shareholders' equity decreased by $0.1 M to $13.6 M ($13.7 M as at June 30, 2012). The following elements had an impact on shareholders' equity in the first quarter of fiscal year 2013: 1) the $269,696 net earnings for the period ended September 30, 2012; 2) the Canadian dollar's appreciation generated an unrealized exchange loss of $0.4 M resulting from the translation of foreign operations, mainly those of the U.S. subsidiaries; and 3) the stock-based compensation costs of $16,174.

CASH FLOWS

A comparison of the Company's cash flows for the periods ended September 30, 2012 and 2011 is presented below:

(in Canadian dollars) (unaudited)	**Three-month period ended September 30, 2012**	**Three-month period ended September 30, 2011**
Cash flows from operating activities	**1,210,214**	1,082,533
Cash flows from investing activities	**(44,123)**	(430,899)
Cash flows from financing activities	**(857,713)**	(367,591)
Effect of exchange rate changes on the balance of cash held in foreign currencies	**(21,685)**	16,153
Net change	**286,693**	300,193
Cash and cash equivalents – Beginning of period	**421,332**	148,836
Cash and cash equivalents – End of period	**708,025**	449,029

Operating activities generated $1,210,214 in cash for the period ended September 30, 2012, compared with $1,082,533 of cash generated during the corresponding period ended September 30, 2011. The rise is mainly attributable to the improvement in net earnings in the first quarter of fiscal year 2013 as compared with the corresponding period ended September 30, 2011 and to the change in working capital items.

For the first quarter of fiscal 2013, investing activities used net cash of ($44,123), mainly attributable to the additional investment of $25,404 ($US25,000) in our Indian joint venture and to acquisition of intangible assets, namely software for our design team.

Financing activities used net cash of ($857,713) in the first quarter of fiscal 2013 compared with ($367,591) of net cash used during the corresponding period ended September 30, 2011. The increase of funds used by financing activities is mainly caused by the reimbursement of bank loans. In addition, the Company started to reimburse its long-term debts after the ending of the two consecutives moratoriums of six months over capital repayments of long-term debts during fiscal year 2012. This had a positive impact on the net debt to equity ratio since management intends to reduce its debt.

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)

(in dollars, except per share data)

	Three-month periods ended				**Last twelve months**
	September 30, 2012	**June 30, 2012**	**March 31, 2012**	**December 31, 2011**	
Revenues	9,982,894	11,561,332	10,222,312	7,056,495	38,823,033
Adjusted EBITDA	726,693	(483,798)	563,603	407,961	1,214,459
Net earnings (loss)	269,696	880,620	(7,651,400)	(1,214,510)	(7,715,594)
EPS basic and diluted	0.004	0.014	(0.127)	(0.020)	(0.129)
Cash flows from operating activities	1,210,214	1,560,416	(419,247)	(1,408,003)	943,380

	Three-month periods ended				**Previous twelve months**
	September 30, 2011	**June 30, 2011**	**March 31, 2011**	**December 31, 2010**	
Revenues	7,069,768	7,826,146	7,126,952	6,354,087	28,376,953
Adjusted EBITDA	323,618	(15,652)	281,125	89,368	678,459
Net loss	(88,216)	(72,989)	(125,006)	(523,693)	(810,886)
EPS basic and diluted	(0.001)	(0.001)	(0.002)	(0.009)	(0.016)
Cash flows from operating activities	1,082,533	441,044	417,595	132,022	2,073,194

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.

The Company's financial strategy is designed to meet the objectives stated above and to respond to changes in economic conditions and the risks characteristics of underlying assets. In order to maintain or adjust its capital structure, the Company may issue or repurchase shares, raise or repay debt or undertake any other activities it considers appropriate under the circumstances.

The Company monitors capital on the basis of its total debt-to-equity ratio. Total debt consists of all interest-bearing debt, and equity is defined as total equity.

The total debt-to equity ratio was as follows:

	September 30, 2012	**June 30, 2012**
	$	$
Bank overdraft	216,719	155,210
Bank loans	2,527,360	2,868,394
Current portion of long-term debt [(a)]	2,362,736	2,580,862
Long-term debt [(a)]	991,171	1,101,760
Total debt	6,097,986	6,706,226
Equity	13,586,291	13,744,227
Total debt-to-equity ratio	44.9%	48.8%

(a) The long-term portion of the loan from another entity has been classified as current portion of long-term debt because the waiver from the lender was obtained in October 2012 which is after the balance sheet date as at September 30, 2012 and as at June 30, 2012.

The Company's financial objectives and strategy described above have remained unchanged since the last reporting period. These objectives and strategies are reviewed annually or more frequently if the need arises.

The Company is not subject to any externally imposed capital requirements other than covenants on its bank loans with its lender to maintain the following levels: 1) a debt ratio lesser than or equal to 2.50:1.00, 2) a working capital ratio greater than or equal to 1.50:1.00, and 3) a determined cumulative adjusted EBITDA and a covenant on the loan from other entity to maintain working capital ratio of 1.50:1.00. Business performance is closely monitored and the most cost-effective methods for raising capital are considered to evaluate compliance with covenants. As at September 30, 2012, the Company was in breach of the working capital and adjusted EBITDA covenants but has received a waiver for this breach from the lender in October 2012.

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, bank loans (including bank overdraft) 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 loans include 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 not respected as at September 30, 2012. Except for covenants relating to the bank loans, the Company is not subject to any other capital requirement imposed by a third party.

ACCOUNTING POLICIES

The reader is invited to refer to the summary of significant accounting policies presented in note 2 to the consolidated financial statements as at June 30, 2012.

OFF-BALANCE SHEET ARRANGEMENTS

As at September 30, 2012, the Company had off-balance sheet arrangements consisting of letters of credit amounting to $1.3 M; these letters of credit expire at various dates through fiscal 2013. In these letters of credit, a deposit certificate secures $1.1 M. The balance, amounting to $0.2 M, was guaranteed by *Export Development Canada*.

CONTROLS AND PROCEDURES

In compliance with the Canadian Securities Administrators' National Instrument 52-109 ("NI 52-109"), the Company has filed certificates signed by the Chief Executive Officer ("CEO") and the Vice President, Finance ("Vice President, 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 Vice President, 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 Company has been made known to them; and
- information required to be disclosed in the Company'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 Vice President, Finance, of the effectiveness of our disclosure controls and procedures. Based on this evaluation, the CEO and the Vice President, Finance concluded that the disclosure controls and procedures are effective, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) on Internal Control – Integrated Framework.

Internal controls over financial reporting

The CEO and the Vice President, 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 IFRS.

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.

CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

September 30, 2012

The comparative figures of the condensed interim consolidated financial statements which are included in this report have not been subject to a review by the Company's external auditors.

For additional information:
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Trading symbols:
TSX Venture: HEO
Alternext: MNEMO: ALHEO

Financial reports, annual reports and press releases are accessible on our website: *www.h2oinnovation.com* and on SEDAR.

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (Unaudited)

	September 30, 2012	June 30, 2012
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	**924,744**	576,542
Guaranteed deposits certificates	**1,147,817**	1,147,703
Accounts receivable (note 3)	**8,047,481**	9,322,380
Inventories (note 4)	**2,731,512**	2,250,789
Costs incurred in excess of billings	**1,919,818**	2,154,311
Prepaid expenses	**95,434**	132,480
	14,866,806	15,584,205
Non-current assets		
Property, plant and equipment	**1,949,679**	2,026,695
Intangible assets	**5,126,269**	5,459,185
Investment in a joint venture	**48,384**	11,722
Other assets	**29,649**	43,122
Goodwill	**2,304,520**	2,386,322
Deferred income tax assets	**2,945,429**	2,958,149
	27,270,736	28,469,400
LIABILITIES		
Current liabilities		
Bank overdraft	**216,719**	155,210
Bank loans	**2,527,360**	2,868,394
Accounts payable and accrued liabilities (note 5)	**5,512,366**	5,742,007
Provisions (note 6)	**55,249**	40,543
Billings in excess of costs incurred	**1,341,918**	1,634,724
Income taxes payable	**84,361**	4,378
Deferred rent	**18,188**	18,188
Current portion of long-term debt (note 8)	**2,362,736**	2,580,862
Contingent considerations (note 7)	**21,139**	21,070
	12,140,036	13,065,376
Non-current liabilities		
Long-term debt (note 8)	**991,171**	1,101,760
Contingent considerations (note 7)	**462,077**	460,555
Deferred rent	**91,161**	97,482
	13,684,445	14,725,173
SHAREHOLDERS' EQUITY		
Share capital	**45,852,436**	45,852,436
Reserve - Stock options	**1,837,595**	1,821,421
Reserve - Warrants	**370,076**	370,076
Deficit	**(32,557,078)**	(32,826,774)
Accumulated other comprehensive loss	**(1,916,738)**	(1,472,932)
	13,586,291	13,744,227
	27,270,736	28,469,400

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

On behalf of the Board,

Frédéric Dugré

President and Chief Executive Officer

Philippe Gervais

Chairman of the Board of Directors

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
For the three-month periods ended September 30, 2012 and 2011
(Unaudited)

ATTRIBUTABLE TO THE SHAREHOLDERS OF H_2O INNOVATION INC.

			Reserves				
	Common shares Number	Share capital	Stock option (note 9)	Warrants	Deficit	Accumulated other comprehensive loss	Total
		$	$	$	$	$	$
Balance as at July 1, 2011	60,145,832	45,852,436	1,734,952	10,143,677	(34,273,772)	(1,922,678)	21,534,615
Stock-based compensation costs	-	-	52,588	-	-	-	52,588
Share issue expenses related to financing	-	-	-	(1,165)	-	-	(1,165)
Net loss for the period	-	-	-	-	(88,216)	-	(88,216)
Other comprehensive loss – Currency translation adjustments	-	-	-	-	-	1,183,948	1,183,948
Balance as at September 30, 2011	**60,145,832**	**45,852,436**	**1,787,540**	**10,142,512**	**(34,361,988)**	**(738,730)**	**22,681,770**
Balance as at July 1, 2012	60,145,832	45,852,436	1,821,421	370,076	(32,826,774)	(1,472,932)	13,744,227
Stock-based compensation costs	-	-	16,174	-	-	-	16,174
Net earnings for the period	-	-	-	-	269,696	-	269,696
Other comprehensive loss – Currency translation adjustments	-	-	-	-	-	(443,806)	(443,806)
Balance as at September 30, 2012	**60,145,832**	**45,852,436**	**1,837,595**	**370,076**	**(32,557,078)**	**(1,916,738)**	**13,586,291**

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

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF EARNINGS (LOSS)
For the three-month periods ended September 30, 2012 and 2011
(Unaudited)

	Three-month ended September 30,	
	2012	2011
	$	$
Revenues (note 13)	**9,982,894**	7,069,768
Cost of goods sold (note 10 a))	**7,520,323**	5,325,081
Gross profit	**2,462,571**	1,744,687
Operating expenses (note 10 a))	**135,772**	105,106
Selling expenses (note 10 a))	**843,154**	864,667
Administrative expenses (note 10 a))	**863,263**	855,092
Depreciation of property, plant and equipment (note 10 b))	**68,484**	77,003
Amortization of intangible assets (note 10 b))	**177,758**	233,624
Other losses / (gains) – net (note 10 c))	**(82,271)**	(351,208)
	2,006,160	1,784,284
Operating earnings (loss)	**456,411**	(39,597)
Finance income	**(4,403)**	(4,571)
Finance costs	**209,522**	198,735
Finance costs – net	**205,119**	194,164
Royalties income from a joint venture	**(7,866)**	(9,190)
Share of (earnings) loss in a joint venture	**(10,538)**	40,833
	186,715	225,807
Earnings (loss) before income taxes	**269,696**	(265,404)
Current income tax expense	**84,361**	-
Deferred tax benefit	**(84,361)**	(177,188)
	-	(177,188)
Net earnings (loss) for the period	**269,696**	(88,216)
Net earnings (loss) per share attributable to the equity holders of the company during the period		
Basic and diluted net earnings (loss) per share	**0.004**	(0.001)
Weighted average number of shares outstanding (note 11)	**60,145,832**	60,145,832

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

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the three-month periods ended September 30, 2012 and 2011
(Unaudited)

	Three month ended September 30,	
	2012	2011
	$	$
Net earnings (loss) for the period	**269,696**	(88,216)
Other comprehensive loss - Items that may be reclassified subsequently to net earnings		
Currency translation adjustments	**(443,806)**	1,183,948
Comprehensive income for the period	**(174,110)**	1,095,732

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

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
For the three-month periods ended September 30, 2012 and 2011
(Unaudited)

	Three-months ended September 30, 2012	2011
	$	$
Cash flows from operating activities		
Earnings (loss) before income taxes for the period	**269,696**	(265,404)
Non-cash items		
Finance costs – net	**205,119**	194,164
Depreciation of property, plant and equipment	**68,484**	77,003
Amortization of intangible assets	**177,758**	233,624
Deferred rent	**(4,596)**	1,322
Stock-based compensation	**16,174**	52,588
Share of (earnings) loss of joint venture	**(10,538)**	40,833
	722,097	334,130
Change in working capital items (note 12a))	**487,994**	749,808
Cash generated operations	**1,210,091**	1,083,938
Interests received	**4,403**	4,571
Income taxes paid	**(4,280)**	(5,976)
Net cash generated by operating activities	**1,210,214**	1,082,533
Cash flows from investing activities		
Disposal of guaranteed deposits certificates	**-**	115,364
Acquisition of guaranteed deposits certificates	**(115)**	-
Acquisition of property, plant and equipment	**(6,876)**	(98,130)
Investment in a joint venture	**(25,453)**	-
Acquisition of intangible assets	**(24,386)**	(6,818)
Disposal of other assets	**12,707**	-
Contingent considerations paid	**-**	(441,315)
Net cash (used in) investing activities	**(44,123)**	(430,899)
Cash flows from financing activities		
Variation of bank loans	**(341,034)**	(233,624)
Long-term debt reimbursement	**(346,508)**	(3,355)
Interest paid	**(170,171)**	(129,447)
Warrant issue expenses	**-**	(1,165)
Net cash (used in) financing activities	**(857,713)**	(367,591)
Net change in cash and cash equivalents	**308,378**	284,040
Effect of exchange rate changes on the balance of cash held in foreign currencies	**(21,685)**	16,153
Increase in cash and cash equivalents	**286,693**	300,193
Cash and cash equivalents - Beginning of period (note 12b))	**421,332**	148,836
Cash and cash equivalents - End of period (note 12b))	**708,025**	449,029

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

1. Description of Business

H_2O Innovation Inc. (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. The head office of the Company is located at 330 Saint-Vallier Street East, suite 340, Quebec City (Quebec), Canada.

2. Basis of Preparation

Basis of preparation

The Company's financial statements are presented in Canadian dollars. All values are rounded at the nearest dollar, except otherwise indicated.

These condensed interim consolidated financial statements have been prepared in accordance with IAS 34, Interim Financial Reporting ("IAS 34").

The IFRS accounting policies that are set out in the Company's consolidated financial statements for the year ended June 30, 2012 were consistently applied to all periods presented. Please refer to note 2 in the Company's consolidated financial statements for the year ended June 30, 2012 for a complete description of the Company's significant accounting policies.

The preparation of financial statements in conformity with IAS 34 requires the use of certain critical accounting estimates. It also requires management to exercise judgment in the process of applying the Company's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant are disclosed in note 3 in the Company's consolidated financial statements for the year ended June 30, 2012 and remained unchanged for the three-month period ended September 30, 2012.

The accompanying unaudited condensed interim consolidated financial statements were prepared on a going concern basis, under the historical cost convention.

These condensed interim consolidated financial statements are intended to provide an update on 2012 annual statements. Accordingly they do not include all the information required for annual financial statements and should be read in conjunction with the Company's 2012 annual audited consolidated financial statements.

On November 13th, 2012 the Board reviewed the accompanying condensed interim consolidated financial statements and authorized its publication.

Standards and interpretations adopted during the period

Starting July 1, 2012, the Company has applied the amendment of IAS 1, Presentation of Financial Statements, that require entities to separate items presented in other comprehensive income into two groups, based on whether or not items may be recycled in the future.

Standards and interpretations issued to be adopted at a later date

Unless otherwise noted, the following revised standards and amendments are effective for annual periods beginning on or after January 1, 2013 with earlier application permitted. The Company has not yet assessed the impact of these standards and amendments or determined whether it will early adopt them.

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

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss are generally recorded in other comprehensive income.

The above revisions are effective for annual periods beginning on or after January 1, 2015 with earlier application permitted.

(ii) IFRS 10, *Consolidated Financial Statements*, requires an entity to consolidate an investee when it has power over the investee, is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12, *Consolidation—Special Purpose Entities* and parts of IAS 27, *Consolidated and Separate Financial Statements*.

(iii) IFRS 11, *Joint Arrangements*, requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, *Interests in Joint Ventures*, and SIC-13, *Jointly Controlled Entities—Non-monetary Contributions by Venturers*.

(iv) IFRS 12, *Disclosure of Interests in Other Entities*, establishes disclosure requirements for interests in other entities, such as subsidiaries, joint arrangements, associates, and unconsolidated structured entities. The standard carries forward existing disclosures and also introduces significant additional disclosure that address the nature of, and risks associated with, an entity's interests in other entities.

(v) IFRS 13, *Fair Value Measurement*, is a comprehensive standard for fair value measurement and disclosure for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and does not always reflect a clear measurement basis or consistent disclosures.

(vi) There have been amendments to existing standards, including IAS 27, *Separate Financial Statements* ("IAS 27"), and IAS 28, *Investments in Associates and Joint Ventures* ("IAS 28"). IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13.

3. Accounts Receivable

	As at September 30, 2012	As at June 30, 2012
	$	$
Accounts receivable	**6,509,157**	8,128,294
Retentions from customers under manufacturing contracts	**1,100,323**	983,900
Allowance for doubtful accounts	**(260,772)**	(258,230)
	7,348,708	8,853,964
Tax credits receivable	**169,692**	180,040
Other receivables	**529,081**	288,376
	8,047,481	9,322,380

4. Inventories

	As at September 30, 2012	As at June 30, 2012
	$	$
Raw materials	**1,019,465**	1,112,301
Finished goods	**1,712,047**	1,138,488
	2,731,512	2,250,789

5. Accounts Payable and Accrued Liabilities

	As at September 30, 2012	As at June 30, 2012
	$	$
Trade accounts payable	**2,971,021**	3,792,052
Other accrued liabilities and accounts payable	**2,541,345**	1,949,955
	5,512,366	5,742,007

6. Provisions

The change in carrying value of the provision for warranties is as follows:

	$
Balance as at June 30, 2011	32,300
Additional provisions recognised	40,116
Less: Payments	(32,760)
Effect of foreign exchange differences	887
Balance as at June 30, 2012	40,543
Additional provisions recognised	**24,894**
Less: Payments	**(8,958)**
Effect of foreign exchange differences	**(1,230)**
Balance as at September 30, 2012	**55,249**

7. Contingent considerations

The change in carrying value is as follows:

	$
Balance as at June 30, 2011	1,419,727
Plus: Unwinding of discount	81,591
Less: Payments	(793,393)
Less: Reduction of contingent consideration through statement of income (loss)	(280,142)
Effect of foreign exchange differences	53,842
Balance as at June 30, 2012	481,625
Plus: Unwinding of discount	**18,323**
Effect of foreign exchange differences	**(16,732)**
	483,216
Less: short-term contingent considerations	**(21,139)**
Balance as at September 30, 2012	**462,077**

8. Long-Term Debt

	As at September 30, 2012	As at June 30, 2012
	$	$
Unsecured – at amortised cost		
Bank loan, denominated in Canadian dollars	**1,291,590**	1,401,737
Loan from other entities, denominated in Canadian dollars	**1,791,000**	1,862,820
Loans from shareholders, denominated in US dollars	**182,567**	322,391
Loan from other entities, denominated in US dollars	**88,750**	95,674
	3,353,907	3,682,622
Less : Current portion	**(2,362,736)**	(2,580,862)
Long-term debt	**991,171**	1,101,760

As at September 30, 2012, the Company is in breach of covenants on the loan from other entity to maintain working capital ratio of 1.5:1 and an equity debt ratio of 2.5:1 but has received a waiver for this breach from the lender in October 2012.

9. Capital Stock

Stock options

The following table summarizes the activity under the Company's stock-based compensation plan.

	Three-month period ended September 30, 2012		Year ended June 30, 2012	
	Number	**Weighted average exercise price**	Number	Weighted average exercise price
		$		$
Outstanding - Beginning of period	**2,477,000**	**0.70**	3,945,000	0.80
Expired	**-**	**-**	(980,000)	1.22
Forfeited	**-**	**-**	(487,500)	0.50
Outstanding - End of period	**2,477,000**	**0.70**	2,477,000	0.70

10. Additional information about the nature of costs components

a) Expenses by nature

	Three-month period ended September 30, 2012	Three-month period ended September 30, 2011
	$	$
Material	**5,818,092**	3,211,400
Changes in inventories of raw material, finished goods and costs incurred in excess of billings	**(296,103)**	514,739
Salaries and fringe benefits	**2,045,866**	1,900,542
Subcontractors and professional fees	**861,781**	750,739
Rent, electricity , insurance and office expenses	**330,111**	230,867
Telecommunications and travel expenses	**283,943**	286,648
Bad debt expenses	**2,541**	-
Other expenses	**316,281**	255,011
Total cost of goods sold, operating, selling and administrative expenses	**9,362,512**	7,149,946

b) Depreciation and amortization

The Company has elected to present depreciation and amortization as a separate line item in its condensed interim consolidated statement of loss, as opposed to reflecting the fraction of such amount that pertains to each of the cost of goods sold, operating expenses, selling expenses and administrative expenses, within those cost categories. The following tables provide: i) a breakdown of the depreciation and amortization expense by cost category as noted above, for the three-month periods ended September 30, 2012 and 2011 and ii) the amounts of cost of goods sold, operating expenses, selling expenses and administrative expenses, if depreciation and amortization were allocated within those cost categories for the periods as noted above.

Depreciation by function	**Three-month period ended September 30, 2012**	Three-month period ended September 30, 2011
	$	$
Cost of goods sold	**30,597**	42,280
Operating expenses	**951**	1,118
Selling expenses	**11,689**	14,886
Administrative expenses	**25,247**	18,719
	68,484	77,003

Amortization by function	**Three-month period ended September 30, 2012**	Three-month period ended September 30, 2011
	$	$
Cost of goods sold	**87,448**	114,945
Selling expenses	**78,374**	107,299
Administrative expenses	**11,936**	11,380
	177,758	233,624

Cost per function including depreciation and amortization	**Three-month period ended September 30, 2012**	Three-month period ended September 30, 2011
	$	$
Cost of goods sold	**7,638,368**	5,482,306
Operating expenses	**136,723**	106,224
Selling expenses	**933,217**	986,852
Administrative expenses	**900,446**	885,191
	9,608,754	7,460,573

c) Other (gains) losses – net

	Three-month period ended September 30, 2012	Three-month period ended September 30, 2011
	$	$
Exchange (gain) loss	**(77,939)**	(297,597)
Other revenues	**(4,332)**	(51,630)
(Gain) Loss on disposal of assets	**-**	(1,981)
	(82,271)	(351,208)

11. Net Earnings (loss) 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-month period ended September 30, 2012	Three-month period ended September 30, 2011
Net earnings (loss)	**$269,696**	($88,216)
Basic and diluted weighted average number of share outstanding	**60,145,832**	60,145,832
Basic and diluted net earnings (loss) per share	**$0.004**	($0.001)
Items excluded from the calculation of diluted net earnings (loss) per share because the exercise price was greater than the average market price of the common shares		
Stock options	**1,952,000**	1,872,750
Warrants (number of equivalent shares)	**2,250,000**	10,179,877

For the three-month periods ended September 30, 2012 and 2011, the diluted net earnings (loss) per share was the same as the basic net earnings (loss) per share, since the effect of the assumed exercise of stock options and warrants to purchase common share is anti-dilutive. Accordingly, the diluted net earnings (loss) per share for these periods was calculated using the basic weighted average number of shares outstanding.

12. Cash Flows

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

	Three-month period ended September 30, 2012	Three-month period ended September 30, 2011
	$	$
Accounts receivable	**1,158,247**	(2,181,284)
Inventories	**(502,338)**	(258,412)
Costs incurred in excess of billings	**213,376**	768,759
Prepaid expenses	**36,451**	46,518
Accounts payable and accrued liabilities	**(155,736)**	2,694,900
Provisions	**15,936**	(22,904)
Billings in excess of costs incurred	**(277,942)**	(297,769)
	487,994	749,808

b) Cash and cash equivalents consist of the following:

	As at September 30, 2012	As at September 30, 2011
	$	$
Beginning of period		
Cash and cash equivalents	**576,542**	440,356
Bank overdraft	**(155,210)**	(291,520)
	421,332	148,836
	2012	2011
	$	$
End of period		
Cash and cash equivalents	**924,744**	646,851
Bank overdraft	**(216,719)**	(197,822)
	708,025	449,029

13. Segment Information

Products from which reportable segments derive their revenues

The Company operates under a single reportable consisting of delivering drinking water and process water production and wastewater treatment systems, including related services.

The following is an analysis of the Company's revenues for the period for the continuing operations.

	Three-month period ended September 30, 2012	Three-month period ended September 30, 2011
	$	$
Revenues from sales of consumables	**2,942,635**	2,765,934
Manufacturing contracts revenues	**7,040,259**	4,303,834
	9,982,894	7,069,768

Geographical information

	Three-month period ended September 30, 2012	Three-month period ended September 30, 2011
	$	$
Revenues from external customers		
Revenue according to geographic location		
Canada	**5,241,543**	1,713,162
United States	**4,103,618**	4,341,033
Tunisia	**-**	293,633
China	**399,258**	235,111
Egypt	**67,841**	161,996
Other	**170,634**	324,833
	9,982,894	7,069,768

Revenues are attributed to the various countries according to the customer's country of residence.

	As at September 30, 2012	As at June 30, 2012
	$	$
Noncurrent assets other than financial instruments and deferred tax assets according to geographic location		
Canada	**1,704,701**	1,732,291
United States	**7,675,767**	8,139,911
	9,380,468	9,872,202

14. Related parties disclosure

Compensation of key management personnel

The remuneration of members of key management personnel during the period was as follows:

	Three-month period ended September 30, 2012	Three-month period ended September 30, 2011
	$	$
Short-term benefits	**234,550**	246,224
Post-employment benefits	**2,608**	3,508
Share-based payments	**13,518**	32,437
	250,676	282,169

The remuneration of key executives is determined by the remuneration committee having regards to the performance of individuals and market trends.

GENERAL INFORMATION

Board of Directors

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, Remuneration and Risks Committee

Key Management

Frédéric Dugré, President & CEO
Josée Riverin, VP Finance
Marc Blanchet, VP Corporate and Legal Affairs & Secretary of the Board
Guillaume Clairet, Executive VP

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

Auditors
Deloitte & Touche L.L.P.

Transfer Agent
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