Interim financial report
First quarter ended September 30, 2009

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

MANAGEMENT REPORT

Dear Shareholders,

For the period ended September 30, 2009, sales reached $8,406,610, compared to $5,549,457 for the three-month period ended September 30, 2008. Of this growth, 69% is organic, while 31% is related to the acquisition of Professional Water Technologies (“PWT”) completed in June 2009. The Company’s gross margin for the quarter was 29.8%, compared to 24.4% for the same period in fiscal 2009. Operating earnings for the quarter was $48,320, compared to an operating loss of ($390,005) for the same period of the previous fiscal year. EBITDA[1] for the quarter was ($72,860), compared to $29,927 for the same period ended September 30, 2008. Excluding unrealized foreign exchange loss, EBITDA for the quarter was $437,404. During the quarter, H_2O Innovation recorded a net loss of ($642,688) ($0.012 per share), compared to a net loss of ($409,271) ($0.009 per share) for the first quarter of fiscal 2009. The sales backlog stood at $22.8 M as at September 30, 2009. The sales backlog is entirely composed of systems and equipment sales and does not include sales of services or consumables.

Although the results of the first quarter of fiscal 2010 are somewhat below Management’s expectations due to the economic climate, the Company has remained solidly committed to follow its long term development strategy. As in the previous quarters of this recession, Management has remained focused on long-term growth and has taken actions to maximize the Company’s commercial and financial successes and create sustained value for shareholders. H_2O Innovation can now count on a sound diversification of the industry market segments and water treatment applications in which it is active.

During the quarter, Management accelerated the efforts initiated in fiscal 2009 to increase the proportion of revenues generated by the sale of consumables and services (which are generally recurring in nature). This proactive and strategic action has been taken to reduce the business risk of over-reliance on the sale of equipments and systems which are somewhat less predictable in nature. For the quarter, sales of services and consumable products amounted to $2,3 M, representing 27% of H_2O Innovation's total sales for the quarter. A steady progress compared to fiscal 2009, during which sales of services and consumable products represented 18% of total sales. Management has stated its mid-term objective to see sales of services and consumable products represent 30% of the Company's total revenue and actions were undertaken during the quarter to reach this goal.

These efforts and actions to raise our level of sales of consumables and services have positively contributed to maintaining the Company’s overall level of sales and gross profit for the quarter. While due to the economic environment our sales of systems and equipments have somewhat declined in the present quarter (as was the case in the previous one compared to the second and third quarters of fiscal 2009), Management believes these will pick up as the economy recovers. In this first quarter of fiscal 2010 as in the last of fiscal 2009, the Company has also been subject to a short-term imbalance of revenues generated from municipal projects compared to revenues generated from industrial projects—the recession having a more sustained impact on the industrial sector. During the quarter, an increase in selling, administrative, and general expenses in proportion of sales was recorded and is in large part attributable to the consolidation of PWT and to the addition of new sales resources to grow the

[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.

Company's sales. This intentional and budgeted short-term increase in selling, administrative and general expenses in proportion of sales is a necessary condition to fuel the Company's long term growth.

The Company has continued to be very active in bids—particularly in the wastewater and water reuse applications—and Management is confident of reaping a fair level of success. Shortly following the end of the quarter, H_2O Innovation announced the signing of three new contracts for wastewater and water reuse projects in the United States. The respected industry publication *Global Water Intelligence* has recently published a research report outlining that water reuse will be the water industry's segment with the highest projected growth rate for the next 6 years, growing at a projected 18% year-over-year. H_2O Innovation will continue to leverage its past experience and expertise in water reuse projects as an important component of its growth strategy. To this end, during the quarter and shortly following its end, the Company added new sales representation agents to cover additional U.S. states selling its patented wastewater and water reuse technologies.

The quarter was also marked by the beginning of the integration process of PWT. The integration is going along as planned and is beginning to show some of its potential. Already, PWT's strong brand name and long standing customer relationships, coupled with H_2O Innovation's client base and organizational support, have helped secure new customers and repeat orders while cementing existing client relationships. More noticeably during the period, PWT made promising forays in additional industrial sectors in Mexico—where it has been active for numerous years—by signing new customers. It also signed its first contract to supply water additives for membrane filtration systems in Ecuador, a first in this market for PWT.

The combined presence of H_2O Innovation and PWT is also making itself felt more significantly in the North American and global water treatment industry. H_2O Innovation has collected numerous mentions in leading trade publications lately and has participated in two of the premiere trade shows of the industry, WEFTEC.09 in Orlando, Florida and IDA World Congress 2009 on Desalination and Water Reuse in Dubai, UAE.

On the international scene, H_2O Innovation remains on the look-out for potential international acquisitions or strategic partnerships and is committed to progressively increasing its international activities by seeking additional systems sales in targeted regions while penetrating new countries with its sales of consumables. With the addition of PWT's sales—which are mostly international—the Company is now recording close to 10% of its sales from international activities, significantly more than the one percent level recorded in fiscal 2009. Increasing H_2O Innovation's international sales reduces the Company's exposure to the U.S. market—where it recorded 80% of its revenue in fiscal 2009—while opening new growth opportunities for the future.

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 Innovation's results of operations and financial position for the quarter ended September 30, 2009, in comparison with the corresponding period ended September 30, 2008. They should be read in conjunction with the consolidated financial statements and accompanying notes. Comparison of Balance sheets as at September 30, 2009 to those as at June 30, 2009 is also included. Some sections of this report contain prospective disclosures, which include risks and uncertainties; therefore the actual results may differ from those forecasted in the prospective declarations. Management and the Company disclaim any obligation to revise or update the prospective disclosures contained in the present document.

The following financial statements and the corresponding figures have not been reviewed by our 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

To become the best in North-America, working with consulting engineers at customizing water treatment systems based on comprehensive analytical and strong technical capabilities to maximize the efficiency, performance and longevity of our 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

Exclusively dedicated to water treatment, H_2O Innovation is establishing itself as a key player in sustainable development and in the field of clean technologies. H_2O Innovation designs, develops, produces and integrates state-of-the-art custom-built water treatment systems for the production of drinking water, the reclamation of water, the treatment of wastewater and industrial process water in municipal, commercial, industrial, mining and energy markets. Additionally, the Company offers complete operating and maintenance solutions for membrane filtration and reverse osmosis systems. H_2O Innovation has approximately 100 employees and eight offices including three manufacturing and assembly plants in Canada and the United States.

RESULTS OF OPERATIONS

Selected financial data
(Unaudited)

Three-month period ended September 30	2009	2008	Change
	$	$	$
Sales	8,406,610	5,549,457	2,857,153
Gross margin	2,508,684	1,352,926	1,155,758
Gross margin	29.8%	24.4%	5.4%
Operating, selling, administrative and general expenses	2,032,132	1,305,151	726,981
Net loss	(642,688)	(409,271)	(233,417)
EBITDA[1]	(72,860)	29,927	(102,787)

Results of operations

When comparing the results of the current quarter with those of the corresponding quarter of the previous year, the reader should keep in mind the impact of the integration of Professional Water Technologies (“PWT”) on the sales and expenses figures. This US-based business was acquired in June 2009.

Sales and gross margin

Sales during this first quarter increased 51% when compared to the corresponding quarter last year, totaling $8,406,610 as at September 30, 2009, in comparison to $5,549,457 as at September 30, 2008. This increase in revenues positively impacted our gross margin, which increased from $1,352,926 to $2,508,684 for the three-month periods ended September 30, 2008 and 2009. The gross margin was up 22.0% in fiscal 2010 compared to fiscal 2009. During the first quarter, the increase in higher margin recurring revenues improved gross margin as well as excess billing over work in process related to an important project due to new non-recurring elements.

Operating expenses

Operating, selling, administrative and general expenses rose from $1,305,151 (23.5% of sales) for the three-month period ended September 30, 2008 to $2,032,132 (24.2% of sales) for the same period ended September 30, 2009. The nominal increase in these expenses was primarily due to the integration of our new U.S. company PWT, which has been generating higher operating, selling, administrative and general expenses in proportion of sales than before; its activities, mostly international, actually involve higher travel expenses.

The increase in intangible assets depreciation in fiscal 2010 compared to fiscal 2009 can mainly be attributed to the acquisitions completed in fiscal 2009.

For the quarter ended September 30, 2009, the stock-based compensation decreased to $9,087 from $97,580 in the corresponding quarter of fiscal 2009. This nominal decrease of $88,493 is mainly due to the decrease in stock purchase option in 2009.

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.

Other incomes and expenses

The significant foreign exchange gain variation of $45,658 as at September 30, 2008, compared to a foreign exchange loss of $552,973 as at September 30, 2009, is mainly attributable to the impact of the weakening of the U.S. dollar against the Canadian dollar on the Company's assets and liabilities in U.S. dollars. This change did not have a majority monetary impact to the Company.

The interest expense on long-term debt, totaling $201,374 as at September 30, 2009, is mainly related to the convertible debenture and the long-term debts incurred during the previous year. Of this amount, $66,790 represents the theoretical and non-monetary part of interest on the convertible debenture and long-term debts.

Expenses related to acquisition and integration costs remained relatively flat compared to 2008, going from $28,510 for the quarter ended September 30, 2008 to $15,500 for the quarter ended September 30, 2009.

Net loss

During the quarter, H_2O Innovation recorded a net loss of ($642,688) ($0.012 per share) compared to a net loss of ($409,271) ($0.009 per share) for the first quarter of fiscal 2009. This nominal increase of $233,417 may be explained by the significant exchange loss on financial assets and liabilities in U.S. dollars.

For the quarter ended September 30, 2009, the Company recognized $73,441 as future income taxes related to variations in future tax liabilities accounted for in the acquisitions of Itasca Systems Inc. and Wastewater Technologies Inc.

Commitments

The Company has entered into long-term lease agreements expiring in 2010, 2012 and 2013 which call for a payment of $1,376,132 for the rental of premises. The minimum annual lease payments over the next four years are $391,926 in 2010, $435,404 in 2011, $382,138 in 2012 and $166,664 in 2013.

Shares outstanding

As at September 30, 2009, the number of outstanding shares is 55,139,948. No shares were issued during the quarter.

Stock-based compensation plan

No stock options were issued during the quarter.

FINANCIAL SITUATION

Before the change in operating working capital, **operating activities** used $245,232 in cash for the period ended September 30, 2009, compared to $49,640 of cash generated during the same period ended September 30, 2008. The increase in funds used by operating activities is primarily attributable to the increase in net loss caused by the foreign exchange loss mostly unrealized at September 30, 2009.

Investing activities required net cash of $84,999 mainly due to fixed assets acquisitions.

Financing activities required cash of $218,750 for the repayment of long-term debt.

ACCOUNTING ESTIMATES AND SIGNIFICANT ACCOUNTING POLICIES

Accounting Estimates

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

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

Changes in accounting policies

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

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 its consolidated financial statements. An analysis of the differences between IFRS and the Company’s accounting standards is underway. This analysis takes 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 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.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

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

During 2009, the Company proceeded with the assistance of external experts to establish diagnosis for the adoption of IFRS. This diagnosis has identified the main differences between the accounting treatments applied by the Company under Canadian GAAP and the IFRS as well as the practical implications related to the measure. The differences were further classified according to their degree of complexity and by the amount of work to implement with respect to the measure.

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

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

FINANCIAL RISK MANAGEMENT AND FINANCIAL RISKS

Risks and uncertainties and risk management practices are described in the Company's 2009 Annual Report under Management's Discussion and Analysis. Risks and uncertainties and risk management practices have not materially changed during the three-month period ended September 30, 2009.

DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING

The Company has designed disclosure controls and procedures to ensure that the information reported in this MD&A, the consolidated financial statements and the related interim documents is properly recorded, processed, summarized and reported to the Company's Audit Committee and Board of Directors. Based on its evaluation, as defined in NI 52-109 of the Canadian Securities Administrators, the Company's management has concluded that, at the end of the interim period ended September 30, 2009, the disclosure controls and procedures and the internal controls over financial reporting are adequately designed and provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

This examination was conducted using the framework and criteria set out in the document entitled "Internal Control-Integrated Framework" released by the Committee of Sponsoring Organizations (COSO).

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

Quarter Report
September 30, 2009

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

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

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

CONSOLIDATED BALANCE SHEETS
(Unaudited)

	As at September 30, 2009	As at June 30, 2009
	$	$
ASSETS		
Current assets		
Cash	**5,359,902**	5,594,406
Held-for-trading investments	**2,019,836**	2,021,070
Accounts receivable	**6,361,185**	10,223,766
Inventories	**1,765,558**	1,784,938
Work in process	**3,081,210**	1,023,259
Prepaid expenses	**257,608**	258,271
Future income taxes	**375,376**	375,376
	19,220,675	21,281,086
Held-to-maturity investment	**41,098**	44,077
Fixed assets	**2,451,745**	2,469,680
Intangible assets	**13,125,346**	13,445,145
Other assets	**49,475**	51,890
Goodwill (Note 2)	**14,616,214**	14,616,214
	49,504,553	51,908,092
LIABILITIES		
Current liabilities		
Accounts payable	**4,964,695**	5,648,683
Excess of billing over work in process	**529,220**	1,346,038
Instalments on long-term debt	**1,030,156**	875,000
	6,524,071	7,869,721
Long-term debt	**3,683,830**	4,053,535
Convertible debenture	**1,266,855**	1,238,607
Deferred rent	**67,579**	76,969
Future income taxes	**2,479,193**	2,552,634
	14,021,528	15,791,466
SHAREHOLDERS' EQUITY		
Equity component of convertible debenture	**301,023**	301,023
Capital stock (Note 3)	**43,778,820**	43,778,820
Contributed surplus	**11,384,570**	11,375,483
Deficit	**(19,981,388)**	(19,338,700)
	35,483,025	36,116,626
	49,504,553	51,908,092

The accompanying notes are an integral part of the consolidated financial statements and provide information on the financial statement presentation.

On behalf of the Board,

Frédéric Dugré
President and Chief Executive Officer

Philippe Gervais
Chairman of the Board of Directors

CONSOLIDATED EARNINGS AND COMPREHENSIVE INCOME
(Unaudited)

Three month period ended September 30	**2009**	2008
	$	$
Sales	**8,406,610**	5,549,457
Cost of goods sold	**5,897,926**	4,196,531
Gross margin	**2,508,684**	1,352,926
Expenses		
Operating, selling, administrative and general expenses	**2,032,132**	1,305,151
Amortization of fixed assets	**69,497**	64,711
Depreciation of intangible assets	**356,095**	281,979
Bank charges and other financial expenses	**16,303**	16,795
Government assistance	**(22,750)**	(23,285)
Stock-based compensation	**9,087**	97,580
	2,460,364	1,742,931
Operating earnings (loss) before the following items	**48,320**	(390,005)
Investment income	**1,295**	17,505
Rental and interest income	**2,492**	16,117
Other income	**1,611**	5,677
Exchange gain (loss)	**(552,973)**	45,658
Interest on long-term debt	**(201,374)**	(75,713)
Acquisition and integration expenses	**(15,500)**	(28,510)
	(764,449)	(19,266)
Loss for the period before income tax	**(716,129)**	(409,271)
Future income taxes	**73,441**	-
Net loss for the period and comprehensive income	**(642,688)**	(409,271)
Basic and diluted loss per share	**(0.012)**	(0.009)
Weighted average number of outstanding common shares	**55,139,948**	47,139,466

The accompanying notes are an integral part of the consolidated financial statements and provide information on the financial statements presentation.

CONSOLIDATED CONTRIBUTED SURPLUS AND DEFICIT
(Unaudited)

Three month period ended September 30	2009	2008
	$	$
Contributed surplus		
Balance, beginning of period	**11,375,483**	9,619,819
Stock-based compensation	**9,087**	97,580
Balance, end of period	**11,384,570**	9,717,399
Deficit		
Balance, beginning of period	**(19,338,700)**	(19,273,552)
Net loss	**(642,688)**	(409,271)
Balance, end of period	**(19,981,388)**	(19,682,823)

The accompanying notes are an integral part of the consolidated financial statements and provide information on the financial statements presentation.

CONSOLIDATED CASH FLOWS
(Unaudited)

Three month period ended September 30	**2009**	2008
	$	$
Cash flows from operating activities		
Net loss	**(642,688)**	(409,271)
Non-cash items		
Change in fair value of held-for-trading investments	**1,234**	(13,769)
Exchange (gain) loss on held-to-maturity investment	**2,535**	(565)
Amortization of fixed assets	**69,497**	64,711
Depreciation of intangible assets	**356,095**	281,979
Stock-based compensation	**9,087**	97,580
Future income taxes	**(73,441)**	-
Change in unrealized foreign exchange gain	**(34,341)**	-
Imputed interest	**66,790**	28,975
	(245,232)	49,640
Change in working capital items (Note 5)	**317,477**	(750,473)
	69,245	(700,833)
Cash flows from investing activities		
Acquisition of held-for-trading investments	**444**	(397)
Disposal of held-for-trading investments	**-**	150,000
Receipt of sales-type lease	**-**	5,808
Acquisition of fixed assets	**(51,562)**	(79,716)
Acquisition of intangible assets	**(36,296)**	(6,204)
Business acquisitions (Note 2)	**-**	(9,808,266)
Other assets	**2,415**	(2,267)
	(84,999)	(9,741,042)
Cash flows from financing activities		
Repayment of bank loan	**-**	(27,259)
Long-term debt reimbursement	**(218,750)**	-
Long-term debt	**-**	3,500,000
Convertible debenture	**-**	1,500,000
Share issue expenses	**-**	(32,734)
	(218,750)	4,940,007
Net change	**(234,504)**	(5,501,868)
Cash and cash equivalents, beginning of period	**5,594,406**	9,549,698
Cash and cash equivalents, end of period	**5,359,902**	4,047,830
Supplementary information		
Interest paid	**73,701**	6,856

Cash flows and cash equivalents comprise cash.

The accompanying notes are an integral part of the consolidated financial statements and provide information on the financial statements presentation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The unaudited interim consolidated financial statements of the Company for the three-month period ended September 30, 2009 have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and should be read in conjunction with the 2009 audited annual consolidated financial statements. The accounting policies are the same as those used for the 2009 audited annual consolidated financial statements, with the exception of the accounting changes listed below.

Changes in accounting policies

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

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 iits consolidated financial statements to IFRS. An analysis of the differences between IFRS and the Company's accounting standards is underway. This analysis is being conducted by takingtakes 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:

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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.

2. BUSINESS ACQUISITIONS

Professional Water Technologies

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

The total consideration of $4,606,746 includes a payment of $4,207,270 (US$3,700,000) in cash. On top of this purchase price, a price adjustment of $349,065 (US$306,978) is added and will be paid in cash. The purchase price will be increased by a maximum of US$2,000,000 if accrued sales reach US$13,100,000 within the 24 months period following the closing of the transaction. Goodwill will be adjusted by any additional consideration. Acquisition costs totalling $50,411 (US$44,333) are in addition to the purchase price.

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

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

2. BUSINESS ACQUISITIONS (CONTINUED)

Itasca Systems, Inc.

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

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

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

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

(i) Goodwill is not deductible for tax purposes

2. BUSINESS ACQUISITIONS (CONTINUED)

Wastewater Technology Inc.

On April 10, 2008, H_2O Innovation completed the acquisition of all shares of Wastewater Technology Inc. ("WTI") through H_2O Innovation USA Inc., a wholly-owned subsidiary of H_2O Innovation. WTI designs, manufactures and assembles wastewater treatment units and systems using patented bioreactor (Bio-Wheel™) and MBR (Bio-Brane™) technologies.

The purchase price of the WTI shares is $2,970,624 (US$2,918,385), paid cash. The purchase price will be increased by a maximum of US$2,000,000 (of which $40,716 (US$40,000) was paid on acquisition) if accrued sales over ten periods of the Bio-Brane™ technology amount to US$32.7 million and if sales of the Bio-Wheel™ or related technologies amount to US$8 million. As at June 30, 2009, an amount of $34,287 (US$33,684) was applied against the goodwill. Goodwill will be adjusted by any additional consideration. Acquisition costs totalling $44,792 (US$44,004) are in addition to the purchase price.

During the period ended at June 30, 2009, the Company's management discovered a discrepancy in its previously reported consolidated financial statements for the fiscal period ended June 30, 2008 in regard to the purchase price allocation of this subsidiary. Consequently, the Company's management decided to restate its financial statements to account for a future tax liability of $1,547,208 and for an increase of its goodwill of $1,155,878, patents of $339,839 and distribution network of $51,491. This restatement had no impact on the Company's consolidated earnings or cash flows.

The results of operations of the acquired company are included in the consolidated earnings since April 10, 2008, the acquisition date. Assets acquired and liabilities assumed on the acquisition date are detailed as follows, at the Canadian dollar equivalent:

Assets	$
Accounts receivable	289,906
Work in process	101,306
Inventories	26,441
Fixed assets	50,939
Patents	3,359,070
Distribution network	508,950
Goodwill	1,155,878
Total assets acquired	5,492,490
Current liabilities	
Bank loan	160,648
Accounts payable	725,088
Notes payable	39,822
Future income taxes	1,547,208
	2,472,766
Cash situation on acquisition	36,408
Final acquisition price	3,056,132

2. BUSINESS ACQUISITION (CONTINUED)

Membrane Systems Inc.

On October 1, 2006, the Company completed the acquisition of the assets of Membrane Systems Corporation ("MSC") through Membrane Systems Inc. ("MSI"), a new subsidiary formed under the laws of Delaware, wholly-owned by the Company, pursuant to the September 6, 2006 Purchase Agreement. MSC specializes in the manufacturing of water treatment systems using membrane technologies such as ultra-filtration, nano-filtration and reverse osmosis.

The purchase price of the MSC assets is US$3,073,400 (this amount comprises the initial acquisition price of US$2,875,000 and an adjustment of US$198,400 computed as per clause ii)). This price may be adjusted as follows: i) if accounts receivable are still not paid 180 days after closing, the purchase price will be reduced by an amount equal to the net book value of such accounts receivable at closing; ii) reduced or increased, if applicable, by an amount equal to the difference between the net book value indicated in the financial statements at closing and US$1,000,000 and iii) increased: a) on June 30, 2007, by an amount equal to 50% of the Earning Before Interests, Taxes, Depreciation and Amortization ("EBITDA") of MSI for the period starting at closing date and ending on June 30, 2007 which exceeds the amount calculated by the following formula: US$1,503.10 multiplied by the number of days between closing and June 30, 2007 b) on June 30, 2008, by an amount equal to 50% of the EBITDA of MSI for the 12-month period ending on such date, which exceeds US$623,692; and c) on June 30, 2009, by an amount equal to 50% of the EBITDA of MSI for the 12-month period ending on such date, which exceeds US$706,836. Any additional consideration will be accounted for as consolidated goodwill when the condition is achieved and that additional consideration is issued or to be issued. During the previous period, a cash consideration of US$215,560 was applied against the goodwill. Acquisition costs of $92,075 were added to this price, $40,072 of which were included in deferred charges as at June 30, 2006.

Groupe OxydH_2O

On July 1, 2002, the Company acquired all issued and outstanding shares of Groupe OxydH_2O. This group includes three companies: Les Systèmes Bioflo Inc., 3765415 Canada Inc. and OxydH_2O Canada Inc.

The final purchase price is $917,268. A balance of $13,789 will be settled with the issue of 6,895 common shares.

3. CAPITAL STOCK

Authorized

Unlimited number of common shares, without par value

As at September 30, 2009	**Number of shares**	**Amount**
		$
Issued and fully paid at the beginning of period	**55,139,948**	**43,765,031**
Shares to be issued		
In settlement of business acquisition (Note 2)	**6,895**	**13,789**
Balance, end of period	**55,146,843**	**43,778,820**

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

(i) During the previous year, the Company made a business acquisition which was partially financed through a 10,476,718 common share issue for $7,192,168. The share issue expenses are $32,734.

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

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

Expenses related to shares issue, including warrants, amount to $191,210. The fair value of the warrants is accounted for as a reduction of issue proceeds and the consideration is accounted for as contributed surplus.

3. CAPITAL STOCK (CONTINUED)

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 3,400,000.

The Company recognizes the compensation cost associated with the granting of stock options. The compensation cost is determined according to the fair value of the options using the Black-Scholes option pricing model. This fair value is recognized entirely at the time of granting, if the granting rewards services accomplished in the past and on a straight-line basis over the vesting period of the stock options if granting is made as an incentive for future services.

During the year ended June 30, 2009, the Company issued 207,000 stock options (1,070,000 in 2008). The weighted average fair value of the options granted during the year ended June 30, 2009 is $0.41 per option ($1.22 in 2008). The weighted average fair value of each option granted was estimated at the grant date using the Black-Scholes option pricing model. The valuation was carried out using the following weighted average assumptions: expected volatility of 80.52%, risk-free rate of 2.36%, expected life of 5 years and no expected dividend (79.52%, 3.73%, 5 years and no dividend, respectively, in 2008).

For the year ended June 30, 2009, the Company recorded $333,662 ($799,967 in 2008) as stock-based compensation for options granted to its directors, officers and key employees.

For the period ended September 30, 2009, the Company recorded $9,087 ($97,580 in 2008) as stock-based compensation for options granted to its directors, officers and key employees.

3. CAPITAL-STOCK (CONTINUED)

Stock-Based Compensation Plan (Continued)

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

	Three-month period ended September 30, 2009		Twelve-month period ended June 30, 2009	
	Number	**Weighted average exercise price**	Number	Weighted average exercise price
		$		$
Outstanding, beginning of period	**1,815,000**	**1.15**	1,671,000	1.26
Assigned	**-**	**-**	207,000	0.41
Expired	**-**	**-**	(25,000)	2.30
Extinguished	**-**	**-**	(38,000)	1.26
Outstanding, end of period	**1,815,000**	**1.15**	1,815,000	1.15
Exercisable, end of period	**1,726,139**	**1.18**	1,691,639	1.21

As at September 30, 2009, the following stock options were granted:

Exercise price range	Number of shares	Weighted average remaining life (periods)	Weighted average exercise price
$0.30 to $0.50	175,000	4.21	0.32
$0.51 to $1.00	532,000	3.76	0.90
$1.01 to $1.50	1,088,000	2.64	1.39
$1.51 to $2.00	20,000	2.67	1.85
$0.30 to $2.00	1,815,000	3.12	1.15

As at September 30, 2009, the following stock options could be exercised:

Exercise price range	Number of shares	Weighted average exercise price
$0.30 to $0.50	92,361	0.32
$0.51 to $1.00	525,778	0.86
$1.01 to $1.50	1,088,000	1.39
$1.51 to $2.00	20,000	1.85
$0.30 to $2.00	1,726,139	1.18

3. CAPITAL-STOCK (CONTINUED)

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 September 30, 2009 and June 30, 2009 and the change during the periods ended on those dates are summarized in the following table:

	Three-month period ended September 30, 2009		Twelve-month period ended June 30, 2009	
	Number	**Weighted average exercise price**	Number	**Weighted average exercise price**
		$		$
Outstanding, beginning of period	**9,179,877**	**0.88**	9,344,179	2.30
Assigned	**-**	**-**	9,179,877	0.88
Expired	**-**	**-**	(9,344,179)	2.30
Outstanding, end of period	**9,179,877**	**O.88**	9,179,877	0.88

As at September 30, 2009, the following warrants were granted:

Maturity date	Number of warrants	Exercise price
December 2011	**7,929,877**	$0.85
June 2013	**1,250,000**	$0.80 on or before June 30, 2010 $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	

4. EARNINGS PER SHARE

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

As at September 30	**2009**	2008
Basic and diluted weighted average number of outstanding common shares	**55,139,948**	47,139,466

For the periods ended September 30, 2009 and 2008, there was no difference in the basic and diluted weighted average number of shares outstanding, since the effect of the stock options, warrants and units described in Note 3 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.

5. CASH FLOWS

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

	2009	2008
	$	$
Accounts receivable	**3,862,581**	1,227,341
Inventories	**19,380**	(93,442)
Work in process	**(2,057,951)**	(941,225)
Prepaid expenses	**663**	135,761
Accounts payable	**(683,988)**	(1,490,775)
Excess of billing over work in process	**(816,818)**	412,814
Deferred rent	**(9,390)**	(947)
	314,477	(750,473)

GENERAL INFORMATION

Directors and Officers

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

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

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