Interim financial report
Third quarter ended
March 31, 2014

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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 March 31, 2014, in comparison with the corresponding period ended March 31, 2013. They should be read in conjunction with the consolidated financial statements and accompanying notes. Comparison of financial situation as at March 31, 2014 to those as at June 30, 2013 is also included. Certain statements set forth in this Management's Discussion and Analysis regarding the operations and the activities of H_2O Innovation as well as other communications by the Company to the public that describe more generally management objectives, projections, estimates, expectations or forecasts may constitute forward-looking statements within the meaning of securities legislation. Forward-looking statements concern analysis and other information based on forecast future results and the estimate of amounts that cannot yet be determined. Forward-looking statements include the use of the words such as "anticipate", "if", "believe", "continue", "could", "estimate", "expect", "intend", "may", "plan", "potential", "predict", "project", "should" or "will" and other similar terms as well as those usually used in the future and the conditional, notably regarding certain assumptions as to the success of a venture. Those forward-looking statements involve a number of risks and uncertainties, which may result in actual and future results of the Company to be materially different than those indicated. Information about the risk factors to which the Company is exposed is provided in the Annual Information Form dated September 24, 2013 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 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 at providing membrane-related water treatment solutions and technologies.

OUR MISSION

To provide safe and integrated water treatment solutions and outstanding customer care in order to secure long-term relationships.

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 projects for the production of drinking water and industrial process water, the reclamation and reuse of water, and the treatment of wastewater. Also, directly and through its affiliates, H_2O Innovation provides services and products complementary to its membrane filtration and reverse osmosis systems. These products consist of a complete line of specialty chemicals and consumables and a complete line of couplings. H_2O Innovation employs approximately 130 resources and has six locations in North America.

NON-IFRS FINANCIAL MEASUREMENTS

In this MD&A, the Company's management uses measures that are not in accordance with IFRS. The measurements "Adjusted earnings before interest, tax depreciation and amortization (adjusted EBITDA)" and "Net Debt" are 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 gains on disposal of property, plant and equipment, changes in fair value of contingent considerations, impairment of intangible assets, impairment of goodwill, stock-based compensation costs, gain on settlement agreement and share of earnings in a joint venture. The reader can establish the link between adjusted EBITDA and net earnings (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 March 31,		**Nine-month periods ended March 31,**	
	2014	2013	**2014**	2013
	$	$	**$**	$
Net earnings (loss) for the period	**(216,314)**	86,834	**(1,186,889)**	845,384
Finance costs – net	**137,693**	177,164	**440,578**	590,304
Income taxes	**(28,553)**	(658)	**98,284**	14,391
Depreciation of property, plant and equipment	**77,342**	72,226	**217,088**	209,533
Amortization of intangible assets	**331,176**	181,148	**704,701**	536,843
Gain on disposal of property, plant and equipment	**(4,644)**	-	**(5,644)**	-
Stock-based compensation costs	**2,422**	7,135	**10,495**	32,483
Gain on settlement agreement	**-**	-	**-**	(404,189)
Share of (earnings) loss in a joint venture	**-**	6,177	**-**	(6,142)
Adjusted EBITDA	**299,122**	530,026	**278,613**	1,818,607

The definition of net debt consists of bank overdraft, bank loans, long-term debt less cash and cash equivalents. The reader can establish the link between net debt and debt. The definition of net debt used by the Company may differ from those used by other companies.

Even though net debt is a non-IFRS measure, it is used by management, analysts, investors and other financial stakeholders to assess the Company's capital management.

	Period ended March 31, 2014	**Period ended June 30, 2013**
	$	$
Bank overdraft	179,068	256,701
Bank loans	3,516,309	3,375,843
Current portion of long-term debt	834,720	2,808,261
Long-term debt	456,607	64,996
Less: Cash and cash equivalents	(921,246)	(303,936)
Net debt	4,065,458	6,201,865

ACQUISITION OF PIEDMONT PACIFIC CORPORATION

On December 5, 2013, the Company acquired all of the issued and outstanding shares of Piedmont Pacific Corporation ("Piedmont"), a company located in Oakland, CA and one of the leading manufacturers in the world of flexible pipe couplings and other pipe fittings for highly corrosive environments. Acquisition cost for this transaction was $4,252,165 ($US3,978,447) including certain working capital adjustments. The acquisition was financed by a bought deal private placement and concurrent additional non-brokered private placement of common shares of the Company at a price of $0.23 per Common Shares for total gross proceeds of $8,001,800.

The acquisition of Piedmont will allow the Company to increase its presence in the membrane desalination industry through a large international sales network that the Company intend to maintain and support actively. Moreover, the Company envision multiplying the number of cross selling opportunities coming from its existing sales network of specialty chemicals which sells chemicals daily to the same clients regularly buying couplings. From a financial perspective, we expect the transaction to be immediately accretive to our earnings. We believe it will allow the Company to have 90% of its operating, selling and administrative expenses covered from the gross margin generated by our consumables sales (chemicals, spare parts, maple products, services and now couplings).

Piedmont was integrated to the current activities of the Company and is benefiting from the testing, warehousing, packing and shipping capabilities of the existing facility in Vista, CA, thus reducing operating costs. The strong experiences of the Company for local and international shipments of specialty chemicals to its client will enable the Company to continue to provide the couplings' clients with an outstanding customer care. Moreover, the engineering experience and capabilities of the Company related to membrane systems design will strengthen the product offering and customer support.

The purchase price allocation is preliminary and based on management best estimates as at March 31, 2014. The final purchase price allocation is expected to be completed as soon as management has gathered all of the significant information available and considered necessary in order to finalize this allocation especially in regards to moulds, and intangible assets such as backlog, client relationships, technical drawings and trademark.

RESULTS OF OPERATIONS

The third quarter of fiscal year 2014 was marked by the efforts deployed by the Company to accelerate the integration of flexible pipe couplings products from Piedmont to its specialty chemical products lines with the goal to expand the product offering to its existing client-base and to allow the Company to maximize the use of its distribution network and the resources already in place.

In order to facilitate this integration, the Company added dedicated staff in its technical and commercial departments as well as in its supply and logistics services in order to meet the growing demand. Since Piedmont's acquisition, some major contracts have been secured which will boost our revenues. Amongst these contracts, we will be providing corrosion resistant flexible couplings for some of the largest desalination plants under construction in the World, such as Sorek (Israel), Carlsbad (USA), Fujairah latest expansion (UAE), Sadara (Saudi Arabia) and Escondida (Chile).

In addition, during this third quarter ended March 31, 2014, the Company continued to be affected by a lower level of delivery of its water treatment projects compared to the corresponding quarter of the previous fiscal year. Even though our recurring sales have increased by 32.8%, from $4.0 M to $5.4 M, our combined revenues were not sufficient to reach profitability. The investment in commercial and technical resources to the water treatment projects sales team in early 2013, reflected in the level of selling expenses, has allowed us to secure more than $20 M of new bookings in the last two quarters. With a backlog of $23.5 M, the Company is in a good position to reach its growth objectives in the upcoming quarters.

Selected financial data
(Unaudited)

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	**2013**	**2014**	**2013**
	$	**$**	$	$
Revenues	**9,826,466**	9,966,644	**26,935,113**	29,368,446
Gross profit before depreciation and amortization	**2,682,096**	2,515,477	**7,132,994**	7,439,109
Gross profit before depreciation and amortization	**27.3%**	25.2%	**26.5%**	25.3%
Operating expenses	**253,535**	218,394	**654,765**	493,535
Selling expenses	**1,053,254**	853,744	**2,971,165**	2,601,528
Administrative expenses	**972,410**	925,700	**2,999,523**	2,642,816
Research and development expenses – net	**51,197**	-	**198,648**	-
Net earnings (loss)	**(216,314)**	86,834	**(1,186,889)**	845,384
Basic and diluted earnings (loss) per share	**(0.002)**	0.001	**(0.015)**	0.014
Adjusted EBITDA	**299,122**	530,026	**278,613**	1,818,607

Revenues and gross profit before depreciation and amortization

Revenues for the third quarter of fiscal year 2014 totaled $9.8 M, compared with $9.9 M in the comparable quarter in fiscal year 2013. This decrease of $0.1 M or 1.4% is attributable to the lower level of revenues from projects deliveries and projects progress which is offset by the higher level of revenues from sales of specialty products and services. Revenues from projects reached $4.4 M for this quarter compared to $5.9 M in the comparable quarter of last fiscal year.

However, revenues from sales of specialty products and services are still progressing, reaching $5.4 M for this quarter compared with $4.0 M in the comparable quarter of fiscal year 2013. This 32.8% increase is mostly the result of our integration of Piedmont's activities. We also have increased our market share in Northeastern United States for maple syrup production equipment and products. The Company continues to deploy efforts to enlarge our specialty chemicals distributors' network and provide after sale services to our systems' clients. The continuous growth of our recurring revenues contributes to stabilize our business model, increases our gross profit and preserves long-term relationships with our clients.

Despite a minor decrease of our revenues during the third quarter of fiscal year 2014, the gross profit before depreciation and amortization reached 27.3% compared to 25.2% in the comparable quarter of fiscal year 2013. This increase is mainly explained by the growing contribution of specialty products and services usually generating higher margin and by constant improvement in project execution. The various initiatives implemented since June 30, 2012 to strengthen both project execution and manufacturing operations continue to contribute favorably to the support of a higher gross profit. Various standards are also being implemented and are aimed at reducing the number of engineering and manufacturing hours allocated to each project.

During the quarter, the Company added $10.6 M in new bookings for water treatment projects. These new bookings, less the revenues realized from water treatment projects during the quarter, have brought up the backlog at $23.5 M as at March 31, 2014, compared to $15.4 M a year ago. This quarter's new bookings include $10.0 M to supply a seawater reverse osmosis (SWRO) system for the Monterey Peninsula Water Supply Project in California, United States. This will be the second largest SWRO system in California and third largest in North America.

Overall, our bookings over revenues ratio over the last two quarters has remained above 2, which is a good indicator that we will assist to an increase of revenues derived from water treatment projects in the coming quarters.

The current pipeline of water treatment projects sales is still rich in opportunities which should allow the Company's sales backlog to support its revenue growth. We maintain strategic and focused bidding activity and management efforts should keep growing the Company's sales backlog at a steady pace.

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

	2013 FY				**2014 FY**			**Last twelve months**	**Previous twelve months**
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**(Q4 FY2013 & Q1 & Q2 & Q3 FY2014)**	(Q4 FY2012 & Q1 & Q2 & Q3 FY2013)
Order backlog	$20.4 M	$18.7 M	$15.4 M	$14.1 M	$12.4 M	$17.3 M	**$23.5 M**	N/A	N/A
Bookings for water treatment projects	$6.7 M	$4.3 M	$2.6 M	$4.3 M	$3.4 M	$9.6 M	**$10.6 M**	**$28.0 M**	$18.3 M
Revenues from water treatment projects	$7.1 M	$6.0 M	$5.9 M	$3.9 M	$5.1 M	$4.7 M	**$4.4 M**	**$18.1 M**	$26.6 M
Bookings / Revenues Ratio	0.9	0.7	0.4	1.1	0.67	2.0	***2.4***	***1.5***	*0.7*
Revenues from specialty chemicals and consumables (usually recurrent in nature)	$2.9 M	$3.4 M	$4.0 M	$2.9 M	$3.2 M	$4.1 M	**$5.4 M**	**$15.6 M**	$14.2 M
Total revenues	$10,0 M	$9.4 M	$9.9 M	$6.8 M	$8.3 M	$8.8 M	**$9.8 M**	**$33.7 M**	$40.8 M

The total revenues for the last twelve months have reached $33.7 M compared to $40.8 M in the previous twelve months, reflecting the slowdown in the water treatment projects activities, despite an increase in revenues from specialty products and services.

The revenues from specialty products and services for the last twelve months have reached $15.6 M, an increase of $1.4 M compared to the previous twelve months. This level of revenues allows the Company to cover an important portion of its selling, operating and administrative expenses ("SG&A"), which contributes to reduce the lumpiness of the water treatment projects activities.

Operating expenses

Showing an increase of approximately $35,000, operating expenses totaled $0.3 M for this quarter compared to $0.2 M for the corresponding quarter of previous fiscal year. This increase is due to the integration of Piedmont which required the addition of new positions to solidify the supply chain, develop new suppliers and to ensure technical delivery of Piedmont products. To a lesser extent, the increase is also due to investments since the second half of fiscal year 2013 to support specialty chemicals products improvement and supply chain and logistics.

Selling expenses

Selling expenses have increased by approximately $200,000 and stood at $1.1 M for this quarter compared with the corresponding quarter of the previous fiscal year, despite the 1.4% decrease in revenues. Selling expenses are linked to bookings and revenues, but do not fluctuate proportionally. The increase is due to the hiring of i) sales managers dedicated to identify new systems and projects opportunities and ii) process and application engineers. The increase of selling expenses is in line with our business plan which objective is to expand our presence in North America in order to increase our water treatment systems' sales on the territory. The level of bookings reached in the last two quarters indicates that our business plan is taking shape.

Administrative expenses

Administrative expenses increased by approximately $47,000 or 5.0% in this third quarter of fiscal year 2014 compared with the third quarter of fiscal year 2013. This increase is mostly related to telecommunications and travel expenses incurred to accelerate the integration to our current operations of Piedmont activities. To help with the integration, we have moved Piedmont's office from Oakland to our actual offices located in Vista, California during the quarter. This way, H_2O maximizes the use of its existing infrastructure and enables Piedmont's customers to benefit of its experience in logistic acquired by the exportation of its specialty chemical products.

The Company's ratio of selling, operating and administrative expenses ("SG&A") as a whole over revenues amounted to 23.2% for this quarter, up from 20.0% for the corresponding quarter of the previous fiscal year. This increase is attributable to a higher level of SG&A expenses, especially selling expenses to support our business plan aimed at increasing our water treatment systems' sales in North America. With the acquisition of Piedmont, management aims to reduce the SG&A ratio to a level similar to last year through an increase of revenues and tighter management of SG&A expenses.

Research and development expenses – net

Management has streamlined the research and development activities into a more structured model to ensure that the objectives included in our 2014 operating plan relying on three pillars: Quality, Innovation and People are met. Therefore, a new function has been identified in the Company's financial statement of earnings to reflect the decisions made in this plan.

For the quarter ended March 31, 2014, gross research and development expenses totaled $69,327, or 0.7% of revenues. For the three-month period ended March 31, 2014, the Company has recorded $18,130 for tax credits from the Canadian provincial government for eligible research and development conducted in Canada.

Adjusted EBITDA

Adjusted EBITDA for the quarter was recorded at $299,122 compared with $530,026 for the same period ended March 31, 2013. Despite a similar level of revenues recorded during the quarter compared with the corresponding quarter of the previous fiscal year at a higher gross profit, the increase in SG&A expenses have contributed to generating a smaller adjusted EBITDA.

Other losses (gains) – net

Other losses (gains) – net amounting to $50,356 for the period ended March 31, 2014 compared with $20,017 for the quarter ended March 31, 2013 are mostly composed of a foreign exchange loss, which is entirely due to exchange rate fluctuations related to working capital items.

Finance costs – net

Finance costs – net totalled $137,693 for the period ended March 31, 2014 compared to $177,164 for the comparable period in the previous fiscal year. These expenses relate mostly to the long-term debt. Of this amount, $25,685 represents the theoretical and non-monetary part of interest on long-term debt. This significant decrease is due to the reimbursement of the Company's long-term debt through a private placement on September 30, 2013 and to the lower level of use of its bank loan due to the bought deal private placement and concurrent non-brokered private placement to support its working capital.

Net earnings (loss)

The net earnings (loss) was ($216,314) or ($0.002) per share for the third quarter of fiscal year 2014 compared with $86,834 or $0.001 per share for the third quarter of fiscal year 2013. The increase of our SG&A expenses impacts the net earnings (loss) and it reflects management's decision to invest in water treatment projects sales teams to fuel the Company's future growth and to reinforce our business model, especially toward the specialty products lines which generate higher margins.

Commitments

The Company has entered into long-term lease agreements expiring in 2015, 2017, 2022 and 2023, which call for lease payments of $4,661,421 for the rental of space. The minimum annual lease payments over the next five years are $630,075 in 2015, $568,847 in 2016, $581,897 in 2017, $475,737 in 2018 and $426,071 in 2019.

Information on share capital

As at March 31, 2014, the Company had 104,632,986 outstanding shares.

FINANCIAL SITUATION

Working capital increased from $2.1 M as at June 30, 2013 (current ratio of 1.17) to $8.2 M as at March 31, 2014 (current ratio of 1.78). The increase is attributable to the $1.6 M, $0.9 M, $1.0 M and $0.9 M increase in accounts receivable, inventories, costs incurred in excess of billings and accounts payable and accrued liabilities respectively, and the decrease of $1.1 M and $2.0 M in billings in excess of costs incurred and current portion of long-term debt respectively.

The net debt which stood at $4.1 M as at March 31, 2014 decreased by nearly $2.1 M compared with $6.2 M as at June 30, 2013. This decrease is mainly attributable to the reimbursement of a portion of the long-term debt and the increase in cash and cash equivalents.

Equity stood at $23.5 M as at March 31, 2014, compared with $14.4 M as at June 30, 2013. As at March 31, 2014 the net debt equity ratio was 0.17 whereas it was 0.43 as at June 30, 2013, showing that the Company is not over leveraged and has improved its overall financial situation.

(in Canadian dollars, except for ratio)	**Period ended March 31, 2014**	**Period ended June 30, 2013**
Working capital	$8,159,668	$2,144,985
Current ratio	1.78	1.17
Net debt[1]	$4,065,458	$6,201,865
Equity	$23,543,336	$14,426,788
Net debt to equity ratio	0.17	0.43

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

As at March 31, 2014 accounts receivable stood at $8.0 M compared with $6.5 M as at June 30, 2013. The increase of $1.5 M is attributable to the higher level of invoicing toward the end of the quarter for water treatment projects, to the acquisition of Piedmont and to a stronger sales volume of equipment and products for the maple syrup production. In addition, retentions from customers under manufacturing contracts related to municipal projects executed during the first nine months of fiscal year 2014 have increased by approximately $0.2 M.

Inventories increased by $0.9 M to $4.9 M as at March 31, 2014 compared with $4.0 M as at June 30, 2013. This increase is largely attributable to finished goods manufactured during the summer and fall in preparation for the maple syrup production season. These finished goods are generally sold during the third quarter and the beginning of the fourth quarter. To a lesser extent, Piedmont's acquisition explains a part of the increase.

Costs incurred in excess of billings increased by $1.0 M to $3.2 M as at March 31, 2014, from $2.2 M as at June 30, 2013, 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 $1.2 M to $0.6 M as at March 31, 2014, from $1.8 M as at June 30, 2013. This decrease is also attributable to differences between project advancement and project invoicing schedules.

Accounts payable and accrued liabilities increased by $0.8 M to $4.9 M as at March 31, 2014, from $4.1 M as at June 30, 2013. This increase is explained by the fact that some large water treatment projects are still into manufacturing and assembly phases which require purchase of material and by the delay in the maple syrup production season.

Overall, the acquisition of Piedmont has increased the level of accounts receivable, inventories and accounts payable and accrued liabilities as of March 31, 2014 compared to June 30, 2013. The Company has recorded a balance of purchase price of a business combination of $252,549 based on the share purchase agreement ("SPA") entered into on December 5, 2013.

The decrease in the current portion of the long-term debt, the balance of which fell from $2.8 M as at June 30, 2013 to $0.8 M as at March 31, 2014, is explained by the lump sum repayment of $1.2 M for the long-term debt with proceeds from the equity issuance by way of private placement completed on September 30, 2013 and monthly repayments.

For the third quarter ended March 31, 2014, shareholders' equity increased by $9.1 M to $23.5 M ($14.4 M as at June 30, 2013). The following elements had an impact on shareholders' equity in the first nine months of fiscal year 2014: 1) the issuance of 44,487,154 common shares by way of two equity private placements for a net proceeds of $9,446,509 ; 2) the ($1,186,889) net loss for the nine-month period ended March 31, 2014; 3) the Canadian dollar's depreciation generated an unrealized exchange gain of $0.81 M resulting from the translation of foreign operations, mainly those of the U.S. subsidiaries; and 3) the stock-based compensation costs of $10,495.

CASH FLOWS

A comparison of the Company's cash flows for the periods ended March 31, 2014 and 2013 is presented below:

(in Canadian dollars) (unaudited)	**Three-month period ended March 31, 2014**	Three-month period ended March 31, 2013	**Nine-month period ended March 31, 2014**	Nine-month period ended March 31, 2013
	$	$	**$**	$
Cash flows from operating activities	**(298,938)**	(1,073,407)	**(2,816,771)**	1,160,757
Cash flows from investing activities	**(25,297)**	(204,511)	**(4,053,667)**	(392,377)
Cash flows from financing activities	**796,786**	732,039	**7,548,928**	(1,034,451)
Effect of exchange rate changes on the balance of cash held in foreign currencies	**59,187**	10,036	**16,453**	(8,381)
Net change	**531,738**	(535,843)	**694,943**	(274,452)
Cash and cash equivalents – Beginning of period	**210,440**	682,723	**47,235**	421,332
Cash and cash equivalents – End of period	**742,178**	146,880	**742,178**	146,880

Operating activities used ($298,938) in cash for the period ended March 31, 2014, compared with ($1,073,407) of cash used during the corresponding period ended March 31, 2013. The increase is mainly attributable to the decline in net loss in the third quarter of fiscal year 2014 as compared with the net earnings in corresponding period ended March 31, 2013 and to the less negative change in working capital items.

For the third quarter of fiscal year 2014, investing activities used net cash of ($25,297), mainly attributable to the Piedmont's acquisition for $13,720, to the acquisition of property, plant and equipment for $4,769 and to the acquisition of intangible assets in the amount of $6,574.

Financing activities generated net cash of $796,786 in the third quarter of fiscal year 2014 compared with $732,039 of net cash generated during the corresponding period ended March 31, 2013. The increase of funds generated by financing activities is mainly caused by the use of bank loans to support our manufacturing activities. In addition, the Company continued to reimburse its long-term debts.

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)

(in dollars, except per share data)

	Three-month period ended				Last twelve months
	March 31, 2014	December 31, 2013	September 30, 2013	June 30, 2013	
Revenues	9,826,466	8,797,428	8,311,219	6,768,455	33,703,568
Adjusted EBITDA	299,122	(90,179)	69,670	(234,355)	44,258
Net earnings (loss)	(216,314)	(500,581)	(469,994)	(532,392)	(1,719,281)
EPS basic and diluted	(0.002)	(0.006)	(0.008)	(0.008)	(0.024)
Cash flows from operating activities	(298,938)	(3,012,316)	494,483	(107,468)	(2,924,239)

	Three-month period ended				Previous twelve months
	March 31, 2013	December 31, 2012	September 30, 2012	June 30, 2012	
Revenues	9,966,644	9,418,908	9,982,894	11,561,332	40,929,778
Adjusted EBITDA	530,026	561,888	726,693	(483,798)	1,334,809
Net earnings (loss)	86,834	488,854	269,696	880,620	1,726,004
EPS basic and diluted	0.001	0.008	0.004	0.014	0.027
Cash flows from operating activities	(1,073,407)	1,024,161	1,210,214	1,560,416	2,721,384

CAPITAL MANAGEMENT

The Company's objective in managing capital is to ensure sufficient liquidity to pursue its growth while at the same time taking a prudent approach towards financial leverage and financial risk.

The Company's capital is composed of net debt and shareholders' equity. Net debt consists of interest-bearing debt less cash. The Company's primary uses of capital are to finance increases in non-cash working capital and capital expenditures for capacity expansion and integration.

The Company monitors its performance through different ratios such as those required under its credit facility and long-term debt arrangements.

Credit facility and long-term debt arrangements require that the Company meet certain financial ratios at fixed points in time. The financial ratios are, as at March 31, 2014:

- Working capital ratio, defined as current assets divided by current liabilities greater than or equal to 1.30:1.00;
- Debt-to-equity ratio, defined as total debt excluding deferred taxes divided by equity of less than or equal to 2.50:1.00; and
- Fixed charge coverage ratio, including all capital and interest payments on borrowings due and capital expenditures, as defined, greater than or equal to 1.00:1.00.

As at March 31, 2014, the Company was in compliance with its financial ratios required for its credit facility and long-term debt arrangements.

ACCOUNTING POLICIES

The reader is invited to refer to the summary of significant accounting policies presented in note 3 to the consolidated financial statements as at June 30, 2013.

CHANGES IN ACCOUNTING POLICIES

The Company has adopted standards along with any consequential amendments, effective July 1, 2013.

a) Consolidated financial statements, joint arrangements, disclosure of interests in other entities

In May 2011, the IASB issued IFRS 10, Consolidated Financial Statements, IFRS 11, *Joint Arrangements* and IFRS 12, *Disclosure of Interests in Other Entities*. 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*.

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*.

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.

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 – 12.

As of July 1, 2012, the interest held in a joint venture by the Company was recognized as a joint venture and accounted for using the equity method until it disposed of it as of March 31, 2013.

The adoption of these new standards and modification did not have a significant impact on the Company's financial position and consolidated results.

b) Fair value measurement

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.

The adoption of this new standard did not have an impact on the calculation of the fair values in the Company's unaudited condensed consolidated financial statements. The adoption of this new standard will require additional disclosures in the audited annual consolidated financial statements of the Company.

OFF-BALANCE SHEET ARRANGEMENTS

As at March 31, 2014, the Company had off-balance sheet arrangements consisting of letters of credit amounting to $1.1 M; these letters of credit expire at various dates through fiscal year 2014. In these letters of credit, a deposit certificate secures $1.0 M. The balance, amounting to $0.1 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)

Third quarter ended
March 31, 2014

For additional information:
Investor Relations
investor@h2oinnovation.com

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)

	March 31, 2014	June 30, 2013
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	**921,246**	303,936
Guaranteed deposits certificates	**1,229,019**	1,253,786
Accounts receivable (note 3)	**8,038,169**	6,468,556
Inventories (note 4)	**4,908,582**	4,016,558
Costs incurred in excess of billings	**3,220,945**	2,203,326
Prepaid expenses	**239,378**	225,493
	18,557,339	14,471,655
Non-current assets		
Property, plant and equipment	**1,937,919**	1,878,759
Intangible assets	**7,283,173**	4,942,884
Other assets	**38,641**	37,851
Goodwill (note 5)	**4,154,844**	2,465,311
Deferred income tax assets	**3,129,584**	3,124,064
	35,101,500	26,920,524
LIABILITIES		
Current liabilities		
Bank overdraft	**179,068**	256,701
Bank loans	**3,516,309**	3,375,843
Accounts payable and accrued liabilities (note 6)	**4,915,959**	4,080,339
Provisions (note 7)	**36,399**	41,637
Billings in excess of costs incurred	**614,502**	1,758,432
Income taxes payable	**38,076**	2,306
Deferred rent	**10,089**	3,151
Balance of purchase price of a business combination (note 5)	**252,549**	-
Current portion of long-term debt (note 8)	**834,720**	2,808,261
	10,397,671	12,326,670
Non-current liabilities		
Long-term debt (note 8)	**456,607**	64,996
Deferred rent	**103,732**	102,070
Deferred income tax liabilities	**600,154**	-
	11,558,164	12,493,736
SHAREHOLDERS' EQUITY		
Share capital (note 9)	**55,298,945**	45,852,436
Reserve - Stock options (note 9)	**1,871,535**	1,861,040
Reserve – Warrants (note 9)	**-**	141,787
Deficit	**(33,330,595)**	(32,285,493)
Accumulated other comprehensive loss	**(296,549)**	(1,142,982)
	23,543,336	14,426,788
	35,101,500	26,920,524

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 nine-month periods ended March 31, 2014 and 2013
(Unaudited)

ATTRIBUTABLE TO THE SHAREHOLDERS OF H_2O INNOVATION INC.

	Common shares Number	Share capital (note 9)	Reserves Stock options (note 9)	Reserves Warrants (note 9)	Deficit	Accumulated other comprehensive loss	Total
		$	$	$	$	$	$
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	-	-	32,483	-	-	-	32,483
Net earnings for the period	-	-	-	-	845,384	-	845,384
Other comprehensive loss – Currency translation adjustments	-	-	-	-	-	(33,301)	(33,301)
Balance as at March 31, 2013	**60,145,832**	**45,852,436**	**1,853,904**	**370,076**	**(31,981,390)**	**(1,506,233)**	**14,588,793**
Balance as at July 1, 2013	60,145,832	45,852,436	1,861,040	141,787	(32,285,493)	(1,142,982)	14,426,788
Issuance of common shares under private placement (note 9)	44,487,154	10,136,805	-	-	-	-	10,136,805
Share issue expenses (note 9)	-	(690,296)	-	-	-	-	(690,296)
Stock-based compensation costs	-	-	10,495	-	-	-	10,495
Reversal to deficit of expired warrants, net of current income taxes (note 9)	-	-	-	(141,787)	141,787	-	-
Net loss for the period	-	-	-	-	(1,186,889)	-	(1,186,889)
Other comprehensive income – Currency translation adjustments	-	-	-	-	-	846,433	846,433
Balance as at March 31, 2014	**104,632,986**	**55,298,945**	**1,871,535**	**-**	**(33,330,595)**	**(296,549)**	**23,543,336**

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 and nine-month periods ended March 31, 2014 and 2013
(Unaudited)

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Revenues (note 13)	**9,826,466**	9,966,644	**26,935,113**	29,368,446
Cost of goods sold (note 10 a))	**7,144,370**	7,451,167	**19,802,119**	21,929,337
Gross profit before depreciation and amortization	**2,682,096**	2,515,477	**7,132,994**	7,439,109
Operating expenses (note 10 a))	**253,535**	218,394	**654,765**	493,535
Selling expenses (note 10 a))	**1,053,254**	853,744	**2,971,165**	2,601,528
Administrative expenses (note 10 a))	**972,410**	925,700	**2,999,523**	2,642,816
Research and development expenses – net (notes 10 a) and c))	**51,197**	-	**198,648**	-
Depreciation of property, plant and equipment (note 10 b))	**77,342**	72,226	**217,088**	209,533
Amortization of intangible assets (note 10 b))	**331,176**	181,148	**704,701**	536,843
Other losses (gains) – net (note 10 d))	**50,356**	20,017	**35,131**	(38,519)
Operating costs total	**2,789,270**	2,271,229	**7,781,021**	6,445,736
Operating (loss) earnings	**(107,174)**	244,248	**(648,027)**	993,373
Finance income	**(5,024)**	(3,770)	**(11,865)**	(11,757)
Finance costs	**142,717**	180,934	**452,443**	602,061
Finance costs – net	**137,693**	177,164	**440,578**	590,304
Gain on settlement agreement	**-**	-	**-**	(404,189)
Royalties income from a joint venture	**-**	(25,269)	**-**	(46,375)
Share of loss (earnings) in a joint venture	**-**	6,177	**-**	(6,142)
Other charges and costs total	**137,693**	158,072	**440,578**	133,598
(Loss) earnings before income taxes	**(244,867)**	86,176	**(1,088,605)**	859,775
Current income tax expense	**9,312**	(658)	**158,221**	98,752
Deferred tax benefit	**(37,865)**	-	**(59,937)**	(84,361)
	(28,553)	(658)	**98,284**	14,391
Net (loss) earnings for the period	**(216,314)**	86,834	**(1,186,889)**	845,384
Net (loss) earnings per share attributable to the equity holders of the company during the period				
Basic and diluted net (loss) earnings per share (note 11)	**(0.002)**	0.001	**(0.015)**	0.014
Weighted average number of shares outstanding (note 11)	**104,632,986**	60,145,832	**81,352,819**	60,145,832

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

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the three-month and nine-month periods ended March 31, 2014 and 2013
(Unaudited)

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Net (loss) earnings for the period	**(216,314)**	86,834	**(1,186,889)**	845,384
Other comprehensive income – Items that may be reclassified subsequently to net earnings				
Currency translation adjustments	**724,671**	262,524	**846,433**	(33,301)
Comprehensive income (loss) for the period	**508,357**	349,378	**(340,456)**	812,083

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

CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
For the three-month and nine-month periods ended March 31, 2014 and 2013
(Unaudited)

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Cash flows from operating activities				
(Loss) earnings before income taxes for the period	**(244,867)**	86,176	**(1,088,605)**	859,775
Non-cash items				
Finance costs – net	**137,693**	177,164	**440,578**	590,304
Depreciation of property, plant and equipment	**77,342**	72,226	**217,088**	209,533
Amortization of intangible assets	**331,176**	181,148	**704,701**	536,843
Gain on disposal of property, plant and equipment	**(4,644)**	-	**(5,644)**	-
Deferred rent	**2,152**	(2,843)	**6,257**	(12,083)
Stock-based compensation	**2,422**	7,135	**10,495**	32,483
Gain on settlement agreement	**-**	-	**-**	(404,189)
Share of loss (earnings) of joint venture	**-**	6,177	**-**	(6,142)
	301,274	527,394	**284,870**	1,806,524
Change in working capital items (note 12 a))	**(604,002)**	(1,604,571)	**(3,110,007)**	(653,244)
Cash (used in) generated by operations	**(302,728)**	(1,077,177)	**(2,825,137)**	1,153,280
Interests received	**5,024**	3,770	**11,865**	11,757
Income taxes paid	**(1,234)**	-	**(3,499)**	(4,280)
Net cash (used in) generated by operating activities	**(298,938)**	(1,073,407)	**(2,816,771)**	1,160,757
Cash flows from investing activities				
Variation of guaranteed deposits certificates	**(897)**	(103,265)	**30,149**	(102,691)
Acquisition of property, plant and equipment	**(4,769)**	(73,168)	**(60,936)**	(122,079)
Investment in a joint venture	**-**	-	**-**	(25,453)
Acquisition of intangible assets	**(6,574)**	(21,721)	**(46,389)**	(52,493)
Variation of other assets	**730**	(6,357)	**730**	6,350
Disposal of property, plant and equipment	**-**	-	**6,798**	-
Business combination, net of cash acquired (note 5)	**(13,787)**	-	**(3,984,019)**	-
Contingent considerations paid	**-**	-	**-**	(96,011)
Net cash used in investing activities	**(25,297)**	(204,511)	**(4,053,667)**	(392,377)
Cash flows from financing activities				
Variation of bank loans	**1,176,601**	1,163,836	**140,466**	350,050
Long-term debt reimbursement	**(254,669)**	(253,888)	**(1,513,237)**	(852,984)
Interest paid	**(124,828)**	(177,909)	**(367,656)**	(531,517)
Issuance of common shares (note 9)	**-**	-	**9,979,651**	-
Payment for share issue expenses (note 9)	**(318)**	-	**(690,296)**	-
Net cash generated (used in) by financing activities	**796,786**	732,039	**7,548,928**	(1,034,451)
Net change in cash and cash equivalents	**472,551**	(545,879)	**678,490**	(266,071)
Effect of exchange rate changes on the balance of cash held in foreign currencies	**59,187**	10,036	**16,453**	(8,381)
Increase (decrease) in cash and cash equivalents	**531,738**	(535,843)	**694,943**	(274,452)
Cash and cash equivalents - Beginning of period (note 12 b))	**210,440**	682,723	**47,235**	421,332
Cash and cash equivalents - End of period (note 12 b))	**742,178**	146,880	**742,178**	146,880

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 provides integrated technological water treatment solutions based on membrane filtration technology to municipal, energy & mining end-users. The Company designs state-of-the-art custom-built water treatment projects for the production of drinking water and industrial process water, the reclamation and reuse of water, and the treatment of wastewater. Also, directly and through its affiliates, The Company provides services and products complementary to its membrane filtration and reverse osmosis systems. These products consist of a complete line of specialty chemicals and consumables and a complete line of couplings. 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, 2013 were consistently applied to all periods presented. Please refer to note 3 in the Company's consolidated financial statements for the year ended June 30, 2013 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, 2013 and remained unchanged for the three-month and nine-month periods ended March 31, 2014.

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 2013 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 2013 annual audited consolidated financial statements.

On May 12th, 2014 the Board reviewed the accompanying condensed interim consolidated financial statements and authorized its publication.

Standards and interpretations adopted during the period

a) Consolidated financial statements, joint arrangements and disclosure of interests in other entities

In May 2011, the IASB issued IFRS 10, Consolidated Financial Statements, IFRS 11, *Joint Arrangements* and IFRS 12, *Disclosure of Interests in Other Entities*. 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*.

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. IFRS 11 supersedes IAS 31, *Interests in Joint Ventures*, and SIC-13, *Jointly Controlled Entities—Non-monetary Contributions by Venturers*.

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.

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, IFRS 11 and IFRS 12.

As of July 1, 2013, the Company has adopted IFRS 10, 11 and 12, and the amendments of IAS 27 and 28. As of July 1, 2012, the interest held in a joint venture by the Company was recognized as a joint venture and accounted for using the equity method until it disposed of it as of March 31, 2013.

The adoption of these new standards and modification did not have a significant impact on the Company's financial position and consolidated results. Given the insignificant impact of the adoption of these amendments on the statement of financial position, these interim condensed consolidated financial statements do not include the statement of financial position as at July 1, 2012.

b) Fair value measurement

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.

The adoption of this new standard did not have an impact on the calculation of the fair values in the Company's unaudited condensed consolidated financial statements. The adoption of this new standard will require additional disclosures in the audited annual consolidated financial statements of the Company.

Standards and interpretations issued to be adopted at a later date

Unless otherwise noted, the following revised standard and amendment are effective for annual periods beginning on or after January 1 2014 (January 1, 2018 for IFRS 9), with earlier application permitted. The Company has not yet assessed the impact of these standard and amendment or determined whether it will early adopt them.

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.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

In May 2013, IASB amended IAS 36, *Impairment of Assets*, which provides guidance on recoverable amount disclosures for non-financial assets. The amendments to IAS 36 must be applied retrospectively for annual periods beginning on or after January 1, 2014. The adoption of these IFRS amendments is not expected to have a significant impact on the financial statements.

IFRIC 21, *Levies*, this interpretation of IAS 37, 'Provisions, Contingent Liabilities and Contingent Assets', applies to the accounting for levies imposed by governments. IAS 37 sets out criteria for the recognition of a liability, one of which is the requirement for the entity to have a present obligation as a result of a past event ("obligating event"). IFRIC 21 clarifies that the obligating event that gives rise to a liability to pay a levy is the activity described in the relevant legislation that triggers the payment of the levy. IFRIC 21 is effective for annual periods commencing on or after January 1, 2014. The Company is currently evaluating the extent of the impact of adoption of this standard.

3. Accounts Receivable

	As at March 31, 2014	As at June 30, 2013
	$	$
Accounts receivable	**6,703,408**	5,634,221
Retentions from customers under manufacturing contracts	**1,198,977**	953,731
Allowance for doubtful accounts	**(477,846)**	(406,890)
Allowance for back charges	**-**	(3,155)
	7,424,539	6,177,907
Tax credits receivable	**127,075**	84,416
Other receivables	**486,555**	206,233
	8,038,169	6,468,556

4. Inventories

	As at March 31, 2014	As at June 30, 2013
	$	$
Raw materials	**1,091,406**	1,058,976
Finished goods	**3,817,176**	2,957,582
	4,908,582	4,016,558

5. Business Combination

Description of the business combination

On December 5, 2013, the Company acquired all of the issued and outstanding shares of Piedmont Pacific Corporation ("Piedmont"), a company located in Oakland, CA and one of the leading manufacturers in the world of flexible pipe couplings and other pipe fittings for highly corrosive environments. Acquisition cost for this transaction was $4,252,165 ($US3,978,447) including certain working capital adjustments. The acquisition was financed by a private placement and concurrent additional non-brokered private placement of common shares of the Company at a price of $0.23 per Common Shares for total gross proceeds of $8,001,800.

Piedmont was integrated to the current activities of the Company and is using the testing, warehousing, packing and shipping capabilities of the existing facility in Vista, CA.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

5. Business Combination (Continued)

Assets acquired and liabilities assumed at the acquisition date

	December 5, 2013 $
Assets	
Current assets	
Cash and cash equivalents	23,981
Accounts receivable	498,140
Inventories	268,148
	790,269
Non-current assets	
Property, plant and equipment	
Machinery and equipment	13,787
Moulds	180,627
Intangible assets	
Backlog	59,425
Client relationships	2,079,885
Technical drawings	59,425
Trademark	470,272
Total	3,653,690
Liabilities	
Current liabilities	
Accounts payable and accrued liabilities	(263,461)
Income taxes payable	(34,434)
Deferred income tax liabilities	(616,911)
Total	(914,806)
Identifiable net assets acquired	2,738,884

The purchase price allocation shown above is preliminary and based on management best estimates as at March 31, 2014. The final purchase price allocation is expected to be completed as soon as management has gathered all of the significant information available and considered necessary in order to finalize this allocation especially in regards to moulds, and intangible assets such as backlog, client relationships, technical drawings and trademark.

Sources and uses of funds at the transaction closing date

	December 5, 2013 $
Sources	
Private placement (note 9)	7,095,200
Concurrent additional non-brokered private placement (note 9)	906,600
	8,001,800
Uses	
Cash consideration transferred	(4,008,000)
Balance of purchase price of a business combination to be paid	(244,165)
Share issue expenses (note 9)	(636,096)
Working capital for the Company's current activities	(3,113,539)
	-

The balance of purchase price of a business combination to be paid has been estimated based on the excess of net assets over the net book value agreed upon in the share purchase agreement as of the transaction closing date.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

5. Business Combination (Continued)

Costs related to the acquisition

The total acquisition-related costs amounted to $46,633 and are included in administrative expenses in the Condensed Interim Consolidated Statement of earnings (loss).

Determination of fair value

At the acquisition date, the identifiable assets acquired and the liabilities assumed are recognized at the acquisition-date fair value.

Accounts receivable, inventories, accounts payable and accrued liabilities and income taxes payable arising from a business combination are recognized at their fair value, which is not substantially different from their gross contractual value and expected receipts and disbursements.

Goodwill is measured as the excess of the total consideration transferred, the amount of any non-controlling interests in the acquiree and the fair value of the acquirer's previously held equity interest in the acquire (if any) over the net balance of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed. If, after remeasurement, the net balance of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed exceeds the total consideration transferred, the amount of any non-controlling interests in the acquiree, and the fair value of the acquirer's previously held interest in the acquiree (if any), the excess amount is recognized immediately in profit or loss as a bargain purchase gain.

Goodwill arising from the business combination

	December 5, 2013 $
Cash consideration transferred and balance of purchase price payable	4,252,165
Less:	
Fair value of net identifiable acquired assets	(2,738,884)
Goodwill	1,513,281

The goodwill recognized from this business combination is not deductible for tax purposes.

Goodwill of $1,513,281 stems essentially from the synergies with other activities of the Company, the economic value of the workforce acquired as well as intangible assets that do not meet the criteria for separate recognition.

Impact of the business combination on the Company's financial performance

The Company's loss for the three-month period ended March 31, 2014 includes $975,136 in revenues and a $177,547 profit generated from Piedmont additional business.

The Company's loss for the nine-month period ended March 31, 2014 includes $1,130,741 in revenues and a $236,630 profit generated from Piedmont additional business.

If the business combination had been completed on July 1, 2013, the Company's consolidated revenues for the nine-month period ended March 31, 2014 would have totalled $27,785,439 and consolidated loss for the nine months ended March 31, 2014 would have been ($1,185,479).

The Company considers the pro forma figures to be an approximate measurement of the financial performance of the combined business over a nine-month period. However, pro forma information does not account for synergies or changes to historical transactions and is not necessarily indicative of the profit of the Company if the acquisition actually occurred on July 1, 2013, nor the profit that may be achieved in the future.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

5. Business Combination (Continued)

To determine the Company's pro forma consolidated revenues and profit if Piedmont had been acquired on July 1, 2013, the Company:

- Calculated depreciation of property, plant and equipment and amortization of other acquired intangible assets based on the fair value arising from initial recognition of the business combination rather than the carrying amounts recognized in the pre-acquisition financial statements.
- Calculated the borrowing costs on the Company's net indebtedness after the business combination.
- Calculated an additional income tax expense to reflect the pro forma adjustments described above.

The change in carrying value of the goodwill is as follows:

	$
Balance as at June 30, 2012	2,386,322
Effect of foreign exchange differences	78,989
Balance as at June 30, 2013	2,465,311
Plus: Business combination - Piedmont	**1,513,281**
Effect of foreign exchange differences	**176,252**
Balance as at March 31, 2014	**4,154,844**

6. Accounts Payable and Accrued Liabilities

	As at March 31, 2014	As at June 30, 2013
	$	$
Trade accounts payable	**2,815,279**	2,178,120
Other accrued liabilities and accounts payable	**2,100,680**	1,902,219
	4,915,959	4,080,339

7. Provisions

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

	$
Balance as at June 30, 2012	40,543
Additional provisions recognised	77,745
Less: Payments	(79,163)
Effect of foreign exchange differences	2,512
Balance as at June 30, 2013	41,637
Additional provisions recognised	**80,804**
Plus: Allocation received	**62,964**
Less: Payments	**(154,261)**
Effect of foreign exchange differences	**5,255**
Balance as at March 31, 2014	**36,399**

8. Long-Term Debt

	As at March 31, 2014	As at June 30, 2013
	$	$
Unsecured – at amortised cost		
Bank loan, denominated in Canadian dollars	**359,400**	1,076,696
Loan from other entities, denominated in Canadian dollars	**858,831**	1,568,924
Loans from shareholders, denominated in US dollars	**-**	145,003
Loan from other entities, denominated in US dollars	**73,096**	82,634
	1,291,327	2,873,257
Less: Current portion	**834,720**	2,808,261
Long-term debt	**456,607**	64,996

On September 30, 2013, the Company used the proceeds from an equity private placement (note 9) to reimbursed $500,000 of its bank loan and $500,000 of its loan from other entities. The Company also issued 714,312 common shares to reimburse the loans from shareholders amounting to $157,154.

9. Capital Stock

Share capital

On September 30, 2013, the Company issued, by way of an equity private placement, 9,704,546 common shares with gross proceeds of $2,135,005, expenses of $54,200 for a net proceeds of $2,080,805. The Company used the proceeds to reimburse partially its long-term debt and to support its working capital. Among the common shares issued in connection with this offering, 714,312 common shares were issued to reimburse the loans from shareholders amounting to $157,154.

On December 5, 2013, the Company issued, by way of a bought deal private placement and concurrent additional non-brokered private placement, 34,782,608 common shares with gross proceeds of $8,001,800, expenses of $636,096 for net proceeds of $7,365,704. The Company used the proceeds to complete the acquisition of Piedmont (note 5) and to support its working capital.

Stock options

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

	Nine-month period ended March 31, 2014		Year ended June 30, 2013	
	Number	**Weighted average exercise price**	Number	Weighted average exercise price
		$		$
Outstanding - Beginning of period	**2,124,500**	**0.57**	2,477,000	0.70
Expired	**(387,000)**	**0.71**	(352,500)	1.50
Outstanding - End of period	**1,737,500**	**0.53**	2,124,500	0.57

Warrants

In the course of its financing transactions made during fiscal year 2011 and previous years, the Company issued warrants entitling them the right to acquire shares at a predetermined price. Each warrant issued entitles the holder to acquire one common share of the Company.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

9. Capital Stock (Continued)

The warrants outstanding as at March 31, 2014 and the change during the period ended on that date are summarized in the following table:

Nine-month period ended March 31,		2014
	Number	Weighted average exercise price
		$
Outstanding, beginning of period	**1,000,000**	**0.50**
Expired on December 31, 2013	**(1,000,000)**	**0.50**
Outstanding, end of period	**-**	**-**

10. Additional information about the nature of costs components

a) Expenses by nature

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Material	**4,683,440**	3,880,162	**14,286,632**	15,090,864
Changes in inventories of raw material, finished goods and costs incurred in excess of billings	**360,120**	1,044,806	**(240,170)**	496,840
Salaries and fringe benefits	**2,710,379**	2,380,418	**7,695,118**	6,635,685
Subcontractors and professional fees	**762,762**	1,070,615	**1,868,465**	2,384,600
Rent, electricity , insurance and office expenses	**401,120**	359,158	**1,138,680**	1,024,380
Telecommunications and travel expenses	**279,807**	290,391	**850,206**	857,651
Bad debt expenses	**30,000**	29,725	**79,695**	55,498
Other expenses	**247,138**	393,731	**947,594**	1,121,699
Total cost of goods sold, operating, selling, administrative and research and development expenses	**9,474,766**	9,449,005	**26,626,220**	27,667,216

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 earnings (loss), as opposed to reflecting the fraction of such amount that pertains to each of the cost of goods sold, operating expenses, selling expenses, administrative expenses and research and development expenses – net, 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 and nine-month periods ended March 31, 2014 and 2013; 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.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

10. Additional information about the nature of costs components (Continued)

b) Depreciation and amortization (Continued)

Depreciation by function	**Three-month periods ended March 31,**		**Nine-month periods ended March 31,**	
	2014	2013	**2014**	2013
	$	$	**$**	$
Cost of goods sold	**47,786**	39,926	**128,012**	100,925
Operating expenses	**863**	933	**2,648**	2,875
Selling expenses	**8,872**	11,376	**28,542**	34,728
Administrative expenses	**19,821**	19,991	**57,886**	71,005
	77,342	72,226	**217,088**	209,533

Amortization by function	**Three-month periods ended March 31,**		**Nine-month periods ended March 31,**	
	2014	2013	**2014**	2013
	$	$	**$**	$
Cost of goods sold	**99,140**	88,593	**282,446**	263,138
Selling expenses	**217,753**	79,364	**380,046**	235,808
Administrative expenses	**14,283**	13,191	**42,209**	37,897
	331,176	181,148	**704,701**	536,843

Cost per function including depreciation and amortization	**Three-month periods ended March 31,**		**Nine-month periods ended March 31,**	
	2014	2013	**2014**	2013
	$	$	**$**	$
Cost of goods sold	**7,291,296**	7,579,686	**20,212,577**	22,293,400
Operating expenses	**254,398**	219,327	**657,413**	496,410
Selling expenses	**1,279,879**	944,484	**3,379,753**	2,872,064
Administrative expenses	**1,006,514**	958,882	**3,099,618**	2,751,718
Research and development expenses – net	**51,197**	-	**198,648**	-

c) Research and development expenses – net

	Three-month periods ended March 31,		**Nine-month periods ended March 31,**	
	2014	2013	**2014**	2013
	$	$	**$**	$
Gross research and development expenses	**65,701**	-	**248,826**	-
Research and development tax credits and grants	**(14,504)**	-	**(50,178)**	-
	51,197	-	**198,648**	-

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

10. Additional information about the nature of costs components (Continued)

d) Other (gains) losses – net

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Exchange (gain) loss	**59,819**	20,813	**62,998**	(30,642)
Other (revenues) charges	**(4,819)**	(796)	**(22,223)**	(7,877)
Gain on disposal of property, plant and equipment	**(4,644)**	-	**(5,644)**	-
	50,356	20,017	**35,131**	(38,519)

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 periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
Net (loss) earnings	**($216,314)**	$86,834	**($1,186,889)**	$845,384
Basic and diluted weighted average number of share outstanding	**104,632,986**	60,145,832	**81,352,819**	60,145,832
Basic and diluted net (loss) earnings per share	**($0.002)**	$0.001	**($0.015)**	$0.014
Items excluded from the calculation of diluted net (loss) earnings per share because the exercise price was greater than the average market price of the common shares or due to their anti-dilutive effect				
Stock options			**1,707,500**	1,743,250
Warrants (number of equivalent shares)			**-**	2,250,000

For the three-month and nine-month periods ended March 31, 2014 and 2013, the diluted net (loss) earnings per share was the same as the basic net (loss) per earnings share, since the effect of the assumed exercise of stock options and warrants to purchase common share is anti-dilutive. Accordingly, the diluted net (loss) earnings per share for these periods was calculated using the basic weighted average number of shares outstanding.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

12. Cash Flows

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

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Accounts receivable	**1,480,334**	(2,149,363)	**(930,383)**	(170,930)
Inventories	**223,164**	732,581	**(497,735)**	31,727
Costs incurred in excess of billings	**(1,664,049)**	(195,658)	**(949,752)**	(35,699)
Prepaid expenses	**(45,286)**	(61,231)	**(11,215)**	(24,473)
Accounts payable and accrued liabilities	**(34,668)**	719,854	**455,099**	(261,821)
Provisions	**(53,269)**	(33,034)	**(7,005)**	(12,128)
Billings in excess of costs incurred	**(510,228)**	(617,720)	**(1,169,016)**	(179,920)
	(604,002)	(1,604,571)	**(3,110,007)**	(653,244)

b) Cash and cash equivalents consist of the following:

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Beginning of period				
Cash and cash equivalents	**385,304**	839,111	**303,936**	576,542
Bank overdraft	**(174,864)**	(156,388)	**(256,701)**	(155,210)
	210,440	682,723	**47,235**	421,332

	Three-month periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
End of period				
Cash and cash equivalents	**921,246**	290,031	**921,246**	290,031
Bank overdraft	**(179,068)**	(143,151)	**(179,068)**	(143,151)
	742,178	146,880	**742,178**	146,880

13. Segment Information

Products from which reportable segments derive their revenues

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

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

13. Segment Information (Continued)

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

	Three-month periods ended March 31, 2014	2013	Nine-month periods ended March 31, 2014	2013
	$	$	**$**	$
Revenues from sales of consumables	**5,364,129**	4,039,391	**12,693,257**	10,424,500
Manufacturing contracts revenues	**4,462,337**	5,927,253	**14,241,856**	18,943,946
	9,826,466	9,966,644	**26,935,113**	29,368,446

Geographical information

Revenue from external customers	Three-month periods ended March 31, 2014	2013	Nine-month periods ended March 31, 2014	2013
	$	$	**$**	$
Revenue according to geographic location				
Canada	**3,555,412**	5,411,425	**10,181,583**	14,984,340
United States	**5,138,557**	3,877,613	**14,277,417**	11,959,964
China	**257,378**	149,036	**979,739**	1,141,303
Switzerland	**45,532**	-	**210,674**	-
Arab Emirates	**291,524**	-	**291,524**	-
Australia	**10,178**	-	**51,174**	-
Israel	**114,189**	-	**114,189**	-
Tunisia	**72,790**	203,766	**122,390**	543,561
Egypt	**24,668**	-	**24,668**	94,648
Other	**316,238**	324,804	**681,755**	644,630
	9,826,466	9,966,644	**26,935,113**	29,368,446

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

	As at March 31, 2014	As at June 30, 2013
	$	$
Non-current assets other than financial instruments and deferred tax assets according to geographic location		
Canada	**1,580,101**	1,693,898
United States	**11,795,835**	7,593,056
	13,375,936	9,286,954

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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 periods ended March 31,		Nine-month periods ended March 31,	
	2014	2013	**2014**	2013
	$	$	**$**	$
Short-term benefits	**236,029**	206,213	**949,279**	660,684
Post-employment benefits	**3,168**	2,800	**8,666**	7,808
Share-based payments	**2,155**	5,885	**9,961**	27,327
	241,352	214,898	**967,906**	695,819

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[3]
Pierre Côté, Director[3]
Élaine C. Phénix, Director [1] [2]
Jean-Réal Poirier, Director [2]
Richard Hoel, Director [1]
Lisa Henthorne, Director [2] [3]
Laurence E. Gamst, Director [1]

[1] Audit Committee
[2] Governance, Remuneration and Risks Committee
[3] Technology and Projects 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.

Independent Auditors
Deloitte LLP

Transfer Agent
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