Interim financial report
Second quarter ended
December 31, 2013

www.h2oinnovation.com
investor@h2oinnovation.com

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 December 31, 2013, in comparison with the corresponding period ended December 31, 2012. They should be read in conjunction with the consolidated financial statements and accompanying notes. Comparison of financial situation as at December 31, 2013 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 135 resources and has six locations in North America.

NON-IFRS FINANCIAL MEASUREMENT

In this MD&A, the Company's management uses a measure that is not in accordance with IFRS. The measurement "Adjusted earnings before interest, tax depreciation and amortization (adjusted EBITDA)" is not defined by IFRS and cannot be formally presented in consolidated financial statements. The definition of adjusted EBITDA does not take into account the Company's losses 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, loss on disposal of investment in a joint venture 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 December 31,		**Six-month periods ended December 31,**	
	2013	2012	**2013**	2012
	$	$	**$**	$
Net earnings (loss) for the period	**(500,581)**	488,854	**(970,575)**	758,550
Finance costs – net	**116,958**	208,021	**302,885**	413,140
Income taxes	**36,545**	15,049	**126,837**	15,049
Depreciation of property, plant and equipment	**67,338**	68,823	**139,746**	137,307
Amortization of intangible assets	**187,139**	177,937	**373,525**	355,695
Gain on disposal of property, plant and equipment	**-**	-	**(1,000)**	-
Stock-based compensation costs	**2,422**	9,174	**8,073**	25,348
Gain on settlement agreement	**-**	(404,189)	**-**	(404,189)
Share of (earnings) loss in a joint venture	**-**	(1,781)	**-**	(12,319)
Adjusted EBITDA	**(90,179)**	561,888	**(20,509)**	1,288,581

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 $4,151,716 ($US3,884,465) and is subject to 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 will be integrated to the current activities of the Company and will benefit from the testing, warehousing, packing and shipping capabilities of the existing facility in Vista, CA, thus reducing operating costs. The strong experience of the Company for local and international shipments of specialty chemicals to its client will enable the Company to continue 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 December 31, 2013. 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 distribution network, trademark, client base and technology.

RESULTS OF OPERATIONS

The second quarter of fiscal year 2014 was marked by the acquisition of Piedmont based in California and the completion of an equity placement in the amount of $8M from institutional shareholders. The acquisition and the financing have improved our financial position and solidified our business model which combines recurring sales of "specialty products and services" and sales of water treatment projects. In fact, the integration of flexible pipe couplings products from Piedmont to our specialty chemical products lines will expand our client offering to our existing client-base and will allow the Company to maximize the use of our distribution network and the resources already in place.

Therefore, the specialty chemicals from PWT, the flexible couplings from Piedmont, the other consumables (filters, membranes, and spare parts) and the after sales services offered by H_2O Innovation are all aggregated under the division "Specialty products and services". Each brand name is kept unchanged to retain the integrity, the awareness and the reputation of our products. Technical sales teams are dedicated to each product line and have the goal to ensure client retention, expand the distributor's network and promote new products.

In parallel with these structuring and strategic actions for the Company, this second quarter ended December 31, 2013, has faced a slowdown in the delivery of its water treatment projects compared to the corresponding quarter of the previous fiscal year. Even though our recurring sales have increased by 19.6%, from $3.4 M to $4.1 M, our combined revenues were not sufficient to maintain profitability. Nonetheless, the addition of commercial and technical resources to the system sales team in early 2013 has allowed us to increase significantly the sales pipeline above $180 M and bring the backlog closer to the $20 M mark, which is a healthier level in our objective to reach profitability.

Management remains confident in the significant improvement of its financial results in the second half of fiscal year 2014. The expected increase of its business volume related to water treatment projects and the sustained increase of its revenue from specialty products and services, including those from the integration of Piedmont, shall generate the required volume of sales to bring its results back to profitability.

Selected financial data
(Unaudited)

	Three-month periods ended December 31, 2013	2012	Six-month periods ended December 31, 2013	2012
	$	**$**	$	$
Revenues	**8,797,428**	9,418,908	**17,108,647**	19,401,802
Gross profit	**2,308,907**	2,461,061	**4,450,898**	4,923,632
Gross profit	**26.2%**	26.1%	**26.0%**	25.4%
Operating expenses	**218,644**	139,369	**401,230**	275,141
Selling expenses	**951,242**	904,630	**1,917,911**	1,747,784
Administrative expenses	**1,108,050**	853,853	**2,027,113**	1,717,116
Research and development expenses – net	**104,044**	-	**147,451**	-
Net earnings (loss)	**(500,581)**	488,854	**(970,575)**	758,550
Basic and diluted earnings (loss) per share	**(0.006)**	0.008	**(0.014)**	0.013
Adjusted EBITDA	**(90,179)**	561,888	**(20,509)**	1,288,581

Revenues and gross profit

Revenues for the second quarter of fiscal year 2014 totaled $8.8 M, compared with $9.4 M in the comparable quarter in fiscal year 2013. This decrease of $0.6 M or 6.6% is largely attributable to the low level of revenues from projects deliveries and projects progress. These revenues reached $4.7 M for this quarter compared to $5.9 M in the comparable quarter of last fiscal year. As mentioned in the first quarter of fiscal year 2014, some of the Company's water treatment projects clients have delayed the delivery or the commissioning of their systems, a situation the Company cannot control. This situation has postponed to the second half of fiscal year 2014 the revenue recognition of these projects.

However, revenues from sales of specialty products and services are still progressing, reaching $4.1 M for this quarter compared with $3.4 M in the comparable quarter of fiscal year 2013. This 19.6% increase is the result of our sustained efforts to: i) enlarge our specialty chemicals distributors' network, ii) provide after sale services to our systems' clients, iii) increase our market shares in Northeastern United States for maple syrup production equipment and products and iv) integrate in December 2013 Piedmont's activities. 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 temporary decrease of our revenues during the second quarter of fiscal year 2014, the gross profit remained slightly over 26%. This stability is mainly explained by the growing contribution of specialty products and services usually generating higher gross profit and by our continuing improvements in our 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 quality control measures are also being implemented and are aimed at optimizing the number of engineering and manufacturing hours allocated to each project.

During the quarter, the Company added $9.6 M in new bookings for water treatment projects. These new bookings, coupled with the revenues realized from water treatment projects during the quarter, have brought up the backlog at $17.3 M as at December 31, 2013, compared to $18.7 M a year ago. This quarter's new bookings include $6.1 M from the energy sector. These new contracts are expected to be delivered within the next 12 months. A significant portion of these contracts should be recognized as revenues during the current fiscal year 2014 and shall allow the Company to reach a level of revenues sufficient to generate profits in the next two quarters.

As for the pipeline of opportunities of water treatment projects sales, it is at its highest level in years. With a visibility over $180 M in identified opportunities in North America, management is confident to see a sustained progression in its backlog in the coming months.

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

	2013 FY				2014 FY		Last twelve months	Previous twelve months
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**(Q3 & Q4 FY2013 & Q1 & Q2 FY2014)**	(Q3 & Q4 FY2012 & Q1 & Q2 FY2013)
Order backlog	$20.4 M	$18.7 M	$15.4 M	$14.1 M	$12.4 M	**$17.3 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**	**$19.9 M**	$21.7 M
Revenues from water treatment projects	$7.1 M	$6.0 M	$5.9 M	$3.9 M	$5.1 M	**$4.7 M**	**$19.6 M**	$27.4 M
Bookings / Revenues Ratio	0.9	0.7	0.4	1.1	0.67	**2.0**	***1.0***	*0.8*
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**	**$14.2 M**	$13.7 M

The total revenues for the last twelve months have reached $33.8 M compared to a record high $41.1 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 $14.2 M, an increase of $500,000 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 $80,000, operating expenses totaled $0.2 M for this quarter compared to $0.1 M for the corresponding quarter of previous fiscal year. This increase is due to the addition of new positions since the second half of fiscal year 2013 to i) support specialty chemicals development, ii) support supply chain of specialty products and iii) optimize overall supply chain and logistics for projects.

Selling expenses

Selling expenses have increased by approximately $47,000 and stood at $0.9 M for this quarter compared with the corresponding quarter of the previous fiscal year, despite the 6.6% 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.

Administrative expenses

Administrative expenses increased by approximately $254,000 or 29.8% in this second quarter of fiscal year 2014 compared with the second quarter of fiscal year 2013. Salaries and fringe benefits have increased following the addition of personnel to support operations during the second half of fiscal year 2013. Professional fees have increased due to the completion of the mediation initiated in the first quarter of fiscal year 2014 and due to the acquisition of Piedmont, which expenses are non-recurring in nature. In addition, telecommunications and travel expenses have increased also in relation with the acquisition of Piedmont, first to complete the due diligence work and second to accelerate its integration to our current operations. Management expects the level of administrative expenses to decrease in the second half of fiscal year 2014.

The Company's ratio of selling, operating and administrative expenses ("SG&A") as a whole over revenues amounted to 25.9% for this quarter, up from 20.1% for the corresponding quarter of the previous fiscal year. This increase is largely attributable to the decline in volume of water treatment projects business due to some clients-related delays and to a higher level of SG&A expenses. With the acquisition of Piedmont, management aims to keep 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 December 31, 2013, gross research and development expenses totaled $122,174, or 1.4% of revenues. For the three-month period ended December 31, 2013, 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 ($90,179), compared with $561,888 for the same period ended December 31, 2012. The lower revenues recorded during the quarter compared with the corresponding quarter of the previous fiscal year, combined with the momentarily higher SG&A expenses also contributed to generating a negative adjusted EBITDA.

Other losses (gains) – net

Other losses (gains) – net amounting to $19,528 for the period ended December 31, 2013 compared with $23,735 for the quarter ended December 31, 2012 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 $116,958 for the period ended December 31, 2013 compared to $208,021 for the comparable period in the previous fiscal year. These expenses relate mostly to the long-term debt. Of this amount, $25,534 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 ($500,581) or ($0.006) per share for the second quarter of fiscal year 2014 compared with $488,854 or $0.008 per share for the second quarter of fiscal year 2013. This deterioration is primarily attributable to lower revenues and higher SG&A expenses despite maintaining a gross profit of 26.2%.

Commitments

The Company has entered into long-term lease agreements expiring in 2014, 2017, 2022 and 2023, which call for lease payments of $4,455,807 for the rental of space. The minimum annual lease payments over the next five years are $564,636 in 2014, $552,363 in 2015, $565,009 in 2016, $506,085 in 2017 and $416,566 in 2018.

Information on share capital

As at December 31, 2013, the Company had 104,632,986 outstanding shares. 34,782,608 shares were issued during this quarter.

FINANCIAL SITUATION

Working capital increased from $2.1 M as at June 30, 2013 (current ratio of 1.17) to $8.1 M as at December 31, 2013 (current ratio of 1.83). The increase is attributable to the $2.9 M, $1.0 M and $0.8 M increase in accounts receivable, inventories and accounts payable and accrued liabilities respectively, and the decrease of $0.7 M and $0.7 M in costs incurred in excess of billings and in billings in excess of costs incurred respectively.

The net debt which stood at $3.6 M as at December 31, 2013 decreased by nearly $2.6 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 reimbursement of the bank loans.

Equity stood at $23.0 M as at December 31, 2013, compared with $14.4 M as at June 30, 2013. As at December 31, 2013 the net debt equity ratio was 0.16 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 December 31, 2013**	**Period ended June 30, 2013**
Working capital	$8,081,822	$2,144,985
Current ratio	1.83	1.17
Net debt[1]	$3,646,645	$6,201,865
Equity	$23,032,876	$14,426,788
Net debt to equity ratio	0.16	0.43

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

As at December 31, 2013 accounts receivable stood at $9.4 M compared with $6.5 M as at June 30, 2013. The increase of $2.9 M is attributable to the higher level of invoicing toward the end of the quarter for water treatment projects 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 six months of fiscal year 2014 have increased by approximately $0.3 M.

Inventories increased by $1.0 M to $5.0 M as at December 31, 2013 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.

Costs incurred in excess of billings decreased by $0.7 M to $1.5 M as at December 31, 2013, 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 $0.7 M to $1.1 M as at December 31, 2013, 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 December 31, 2013, from $4.1 M as at June 30, 2013. This increase is explained by the fact that several large water treatment projects have entered into manufacturing and assembly phases which require purchase of material.

Overall, the acquisition of Piedmont has increased the level of accounts receivable, inventories and accounts payable and accrued liabilities as of December 31, 2013 compared to June 30, 2013. The Company has recorded a balance of purchase price of a business combination of $143,017 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 $0.9 M as at December 31, 2013, is explained by the 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.

For the second quarter ended December 31, 2013, shareholders’ equity increased by $8.6 M to $23.0 M ($14.4 M as at June 30, 2013). The following elements had an impact on shareholders’ equity in the first six months of fiscal year 2014: 1) the issuance of 44,487,254 common shares by way of two equity private placements for a net proceeds of $9,446,827 ; 2) the ($970,575) net loss for the six-month period ended December 31, 2013; 3) the Canadian dollar’s appreciation generated an unrealized exchange gain of $0.1 M resulting from the translation of foreign operations, mainly those of the U.S. subsidiaries; and 3) the stock-based compensation costs of $8,073.

CASH FLOWS

A comparison of the Company's cash flows for the periods ended December 31, 2013 and 2012 is presented below:

(in Canadian dollars) (unaudited)	**Three-month period ended December 31, 2013**	Three-month period ended December 31, 2012	**Six-month period ended December 31, 2013**	Six-month period ended December 31, 2012
	$	$	**$**	$
Cash flows from operating activities	**(3,012,316)**	1,024,161	**(2,517,833)**	2,234,375
Cash flows from investing activities	**(3,993,270)**	(143,743)	**(4,028,370)**	(187,866)
Cash flows from financing activities	**7,279,043**	(908,777)	**6,752,142**	(1,766,490)
Effect of exchange rate changes on the balance of cash held in foreign currencies	**(37,718)**	3,057	**(42,734)**	(18,628)
Net change	**235,739**	(25,302)	**204,329**	261,391
Cash and cash equivalents – Beginning of period	**(25,299)**	708,025	**47,235**	421,332
Cash and cash equivalents – End of period	**210,440**	682,723	**210,440**	682,723

Operating activities used ($3,012,316) in cash for the period ended December 31, 2013, compared with $1,024,161 of cash generated during the corresponding period ended December 31, 2012. The decrease is mainly attributable to the significant decline in net loss in the second quarter of fiscal year 2014 as compared with the net earnings in corresponding period ended December 31, 2012 and to the negative change in working capital items.

For the second quarter of fiscal year 2014, investing activities used net cash of ($3,993,270), mainly attributable to the Piedmont's acquisition for $3,970,232, to the acquisition of property, plant and equipment, namely an update of our servers room and various items for $36,165 and to the acquisition of intangible assets, namely the development of dosage software for our specialty chemicals and various software in the amount of $23,486.

Financing activities generated net cash of $7,279,043 in the second quarter of fiscal year 2014 compared with ($908,777) of net cash used during the corresponding period ended December 31, 2012. Proceeds from the bought deal private placement and concurrent additional non-brokered private placement generated net cash flows amounting to $7,366,022. These funds were used to complete the acquisition of Piedmont and to reimburse the Company's bank loans. This had a positive impact on the net debt to equity ratio since management intends to reduce the Company's debt and it will also have a positive impact on the finance costs which will be significantly reduced through the end of fiscal year 2014.

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)

(in dollars, except per share data)

	Three-month period ended				Last twelve months
	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013	
Revenues	8,797,428	8,311,219	6,768,455	9,966,644	33,843,746
Adjusted EBITDA	(90,179)	69,670	(234,355)	530,026	275,162
Net earnings (loss)	(500,581)	(469,994)	(532,392)	86,834	(1,416,133)
EPS basic and diluted	(0.006)	(0.008)	(0.008)	0.001	(0.021)
Cash flows from operating activities	(3,012,316)	494,483	(107,468)	(1,073,407)	(3,698,708)

	Three-month period ended				Previous twelve months
	December 31, 2012	September 30, 2012	June 30, 2012	March 31, 2012	
Revenues	9,418,908	9,982,894	11,561,332	10,222,312	41,185,446
Adjusted EBITDA	561,888	726,693	(483,798)	563,603	1,368,386
Net earnings (loss)	488,854	269,696	880,620	(7,651,400)	(6,012,230)
EPS basic and diluted	0.008	0.004	0.014	(0.127)	(0.101)
Cash flows from operating activities	1,024,161	1,210,214	1,560,416	(419,247)	3,375,544

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 December 31, 2013:

- 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 December 31, 2013, 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 December 31, 2013, the Company had off-balance sheet arrangements consisting of letters of credit amounting to $1.2 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 $0.2 M, was guaranteed by *Export Development Canada*.

CONTROLS AND PROCEDURES

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

Disclosure controls and procedures

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

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

An evaluation was carried out, under the supervision of the CEO and the Vice President, Finance, of the effectiveness of our disclosure controls and procedures. Based on this evaluation, the CEO and the Vice President, Finance concluded that the disclosure controls and procedures are effective, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) on Internal Control – Integrated Framework.

Internal controls over financial reporting

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

Changes in internal controls over financial reporting

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

CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Second quarter ended
December 31, 2013

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)

	December 31, 2013	June 30, 2013
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	**385,304**	303,936
Guaranteed deposits certificates	**1,223,923**	1,253,786
Accounts receivable (note 3)	**9,432,073**	6,468,556
Inventories (note 4)	**5,036,247**	4,016,558
Costs incurred in excess of billings	**1,495,359**	2,203,326
Prepaid expenses	**191,833**	225,493
	17,764,739	14,471,655
Non-current assets		
Property, plant and equipment	**1,806,477**	1,878,759
Intangible assets	**4,657,068**	4,942,884
Other assets	**38,185**	37,851
Goodwill (note 5)	**6,106,125**	2,465,311
Deferred income tax assets	**3,024,708**	3,124,064
	33,397,302	26,920,524
LIABILITIES		
Current liabilities		
Bank overdraft	**174,864**	256,701
Bank loans	**2,339,708**	3,375,843
Accounts payable and accrued liabilities (note 6)	**4,860,224**	4,080,339
Provisions (note 7)	**89,380**	41,637
Billings in excess of costs incurred	**1,103,950**	1,758,432
Income taxes payable	**26,047**	2,306
Deferred rent	**4,547**	3,151
Balance of purchase price of a business combination (note 5)	**143,017**	-
Current portion of long-term debt (note 8)	**941,180**	2,808,261
	9,682,917	12,326,670
Non-current liabilities		
Long-term debt (note 8)	**576,197**	64,996
Deferred rent	**105,312**	102,070
	10,364,426	12,493,736
SHAREHOLDERS' EQUITY		
Share capital (note 9)	**55,299,263**	45,852,436
Reserve - Stock options (note 9)	**1,869,113**	1,861,040
Reserve – Warrants (note 9)	**-**	141,787
Deficit	**(33,114,281)**	(32,285,493)
Accumulated other comprehensive loss	**(1,021,219)**	(1,142,982)
	23,032,876	14,426,788
	33,397,302	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 six-month periods ended December 31, 2013 and 2012
(Unaudited)

ATTRIBUTABLE TO THE SHAREHOLDERS OF H_2O INNOVATION INC.

			Reserves				
	Common shares Number	**Share capital** (note 9)	**Stock options** (note 9)	**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	-	-	25,348	-	-	-	25,348
Net earnings for the period	-	-	-	-	758,550	-	758,550
Other comprehensive loss – Currency translation adjustments	-	-	-	-	-	(295,845)	(295,845)
Balance as at December 31, 2012	**60,145,832**	**45,852,436**	**1,846,769**	**370,076**	**(32,068,224)**	**(1,768,777)**	**14,232,280**
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)	-	(689,978)	-	-	-	-	(689,978)
Stock-based compensation costs	-	-	8,073	-	-	-	8,073
Reversal to deficit of expired warrants, net of current income taxes (note 9)	-	-	-	(141,787)	141,787	-	-
Net loss for the period	-	-	-	-	(970,575)	-	(970,575)
Other comprehensive income – Currency translation adjustments	-	-	-	-	-	121,761	121,761
Balance as at December 31, 2013	**104,632,986**	**55,299,263**	**1,869,113**	**-**	**(33,114,281)**	**(1,021,219)**	**23,032,876**

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 six-month periods ended December 31, 2013 and 2012
(Unaudited)

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Revenues (note 13)	**8,797,428**	9,418,908	**17,108,647**	19,401,802
Cost of goods sold (note 10 a))	**6,488,521**	6,957,847	**12,657,749**	14,478,170
Gross profit	**2,308,907**	2,461,061	**4,450,898**	4,923,632
Operating expenses (note 10 a))	**218,644**	139,369	**401,230**	275,141
Selling expenses (note 10 a))	**951,242**	904,630	**1,917,911**	1,747,784
Administrative expenses (note 10 a))	**1,108,050**	853,853	**2,027,113**	1,717,116
Research and development expenses – net (notes 10 a) and c))	**104,044**	-	**147,451**	-
Depreciation of property, plant and equipment (note 10 b))	**67,338**	68,823	**139,746**	137,307
Amortization of intangible assets (note 10 b))	**187,139**	177,937	**373,525**	355,695
Other losses (gains) – net (note 10 d))	**19,528**	23,735	**(15,225)**	(58,536)
	2,655,985	2,168,347	**4,991,751**	4,174,507
Operating earnings (loss)	**(347,078)**	292,714	**(540,853)**	749,125
Finance income	**(3,304)**	(3,584)	**(6,841)**	(7,987)
Finance costs	**120,262**	211,605	**309,726**	421,127
Finance costs – net	**116,958**	208,021	**302,885**	413,140
Gain on settlement agreement	**-**	(404,189)	**-**	(404,189)
Royalties income from a joint venture	**-**	(13,240)	**-**	(21,106)
Share of earnings in a joint venture	**-**	(1,781)	**-**	(12,319)
	116,958	(211,189)	**302,885**	(24,474)
Earnings (loss) before income taxes	**(464,036)**	503,903	**(843,738)**	773,599
Current income tax expense	**54,209**	15,049	**148,909**	99,410
Deferred tax benefit	**(17,664)**	-	**(22,072)**	(84,361)
	36,545	15,049	**126,837**	15,049
Net earnings (loss) for the period	**(500,581)**	488,854	**(970,575)**	758,550
Net earnings (loss) per share attributable to the equity holders of the company during the period				
Basic and diluted net earnings (loss) per share (note 11)	**(0.006)**	0.008	**(0.014)**	0.013
Weighted average number of shares outstanding (note 11)	**80,439,489**	60,145,832	**69,965,781**	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 six-month periods ended December 31, 2013 and 2012
(Unaudited)

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Net earnings (loss) for the period	**(500,581)**	488,854	**(970,575)**	758,550
Other comprehensive income – Items that may be reclassified subsequently to net earnings				
Currency translation adjustments	**384,315**	147,961	**121,761**	(295,845)
Comprehensive income (loss) for the period	**(116,266)**	636,815	**(848,814)**	462,705

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 six-month periods ended December 31, 2013 and 2012
(Unaudited)

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Cash flows from operating activities				
Earnings (loss) before income taxes for the period	**(464,036)**	503,903	**(843,738)**	773,599
Non-cash items				
Finance costs – net	**116,958**	208,021	**302,885**	413,140
Depreciation of property, plant and equipment	**67,338**	68,823	**139,746**	137,307
Amortization of intangible assets	**187,139**	177,937	**373,525**	355,695
Gain on disposal of property, plant and equipment	**-**	-	**(1,000)**	-
Deferred rent	**2,066**	(4,644)	**4,105**	(9,240)
Stock-based compensation	**2,422**	9,174	**8,073**	25,348
Gain on settlement agreement	**-**	(404,189)	**-**	(404,189)
Share of earnings of joint venture	**-**	(1,781)	**-**	(12,319)
	(88,113)	557,244	**(16,404)**	1,279,341
Change in working capital items (note 12 a))	**(2,927,424)**	463,333	**(2,506,005)**	951,327
Cash generated by (used in) operations	**(3,015,537)**	1,020,577	**(2,522,409)**	2,230,668
Interests received	**3,304**	3,584	**6,841**	7,987
Income taxes paid	**(83)**	-	**(2,265)**	(4,280)
Net cash generated by (used in) operating activities	**(3,012,316)**	1,024,161	**(2,517,833)**	2,234,375
Cash flows from investing activities				
Variation of guaranteed deposits certificates	**30,815**	689	**31,046**	574
Acquisition of property, plant and equipment	**(36,165)**	(42,035)	**(56,167)**	(48,911)
Investment in a joint venture	**-**	-	**-**	(25,453)
Acquisition of intangible assets	**(23,486)**	(6,386)	**(39,815)**	(30,772)
Disposal of other assets		-	**-**	12,707
Disposal of property, plant and equipment	**5,798**	-	**6,798**	-
Business combination, net of cash acquired (note 5)	**(3,970,232)**	-	**(3,970,232)**	-
Contingent considerations paid	**-**	(96,011)	**-**	(96,011)
Net cash used in investing activities	**(3,993,270)**	(143,743)	**(4,028,370)**	(187,866)
Cash flows from financing activities				
Variation of bank loans	**256,554**	(472,752)	**(1,036,135)**	(813,786)
Long-term debt reimbursement	**(252,648)**	(252,588)	**(1,258,568)**	(599,096)
Interest paid	**(88,610)**	(183,437)	**(242,828)**	(353,608)
Issuance of common shares (note 9)	**8,001,800**	-	**9,979,651**	-
Payment for share issue expenses (note 9)	**(638,053)**	-	**(689,978)**	-
Net cash (used in) generated by financing activities	**7,279,043**	(908,777)	**6,752,142**	(1,766,490)
Net change in cash and cash equivalents	**273,457**	(28,359)	**205,939**	280,019
Effect of exchange rate changes on the balance of cash held in foreign currencies	**(37,718)**	3,057	**(42,734)**	(18,628)
Increase (decrease) in cash and cash equivalents	**235,739**	(25,302)	**163,205**	261,391
Cash and cash equivalents - Beginning of period (note 12 b))	**(25,299)**	708,025	**47,235**	421,332
Cash and cash equivalents - End of period (note 12 b))	**210,440**	682,723	**210,440**	682,723

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

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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 six-month periods ended December 31, 2013.

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 February 11th, 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, 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*.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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 (date to be determined 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 December 31, 2013	As at June 30, 2013
	$	$
Accounts receivable	**8,423,860**	5,634,221
Retentions from customers under manufacturing contracts	**1,271,935**	953,731
Allowance for doubtful accounts	**(447,441)**	(406,890)
Allowance for back charges	**-**	(3,155)
	9,248,354	6,177,907
Tax credits receivable	**111,722**	84,416
Other receivables	**71,997**	206,233
	9,432,073	6,468,556

4. Inventories

	As at December 31, 2013	As at June 30, 2013
	$	$
Raw materials	**1,087,079**	1,058,976
Finished goods	**3,949,168**	2,957,582
	5,036,247	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 $4,151,716 ($US3,884,465) and is subject to 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 will be integrated to the current activities of the Company and will use 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
Total	804,056
Liabilities	
Current liabilities	
Accounts payable and accrued liabilities	(262,227)
Income taxes payable	(20,933)
Total	(283,160)
Identifiable net assets acquired	520,896

The purchase price allocation shown above is preliminary and based on management best estimates as at December 31, 2013. 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 distribution network, trademark, client base and technology.

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	(143,716)
Share issue expenses (note 9)	(635,778)
Working capital for the Company's current activities	(3,214,306)
	-

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.

Costs related to the acquisition

The total acquisition-related costs amounted to $33,764 and are included in administrative expenses in the Condensed Interim Consolidated Statement of earnings (loss).

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

5. Business Combination (Continued)

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	4,151,716
Less:	
Fair value of net identifiable acquired assets	(520,896)
Goodwill	3,630,820

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

Goodwill of $3,630,820 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 months and six months ended December 31, 2013 includes 155,605 $ in revenues and a $59,083 profit generated from Piedmont additional business.

If the business combination had been completed on July 1, 2013, the Company's consolidated revenues for the six-month period ended December 31, 2013 would have totalled $17,959,008 and consolidated loss for the six months ended December 31, 2013 would have been ($894,772). The Company's consolidated revenues for the three-month period ended December 31, 2013 would have totalled $9,292,155 and consolidated loss for the three-month period ended December 31, 2013 would have been ($449,519).

The Company considers the pro forma figures to be an approximate measurement of the financial performance of the combined business over a six-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.

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.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

5. Business Combination (Continued)

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	**3,630,820**
Effect of foreign exchange differences	**9,994**
Balance as at December 31, 2013	**6,106,125**

6. Accounts Payable and Accrued Liabilities

	As at December 31, 2013	As at June 30, 2013
	$	$
Trade accounts payable	**2,835,904**	2,178,120
Other accrued liabilities and accounts payable	**2,024,320**	1,902,219
	4,860,224	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	**52,980**
Plus: Allocation received	**62,964**
Less: Payments	**(69,466)**
Effect of foreign exchange differences	**1,265**
Balance as at December 31, 2013	**89,380**

8. Long-Term Debt

	As at December 31, 2013	As at June 30, 2013
	$	$
Unsecured – at amortised cost		
Bank loan, denominated in Canadian dollars	**473,845**	1,076,696
Loan from other entities, denominated in Canadian dollars	**968,700**	1,568,924
Loans from shareholders, denominated in US dollars	**-**	145,003
Loan from other entities, denominated in US dollars	**74,832**	82,634
	1,517,377	2,873,257
Less: Current portion	**941,180**	2,808,261
Long-term debt	**576,197**	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 $635,778 for net proceeds of $7,366,022. 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.

	Six-month period ended December 31, 2013		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 December 31, 2013 and the change during the period ended on that date are summarized in the following table:

Six-month period ended December 31,		2013
	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 December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Material	**5,176,350**	5,392,610	**9,603,192**	11,210,702
Changes in inventories of raw material, finished goods and costs incurred in excess of billings	**(529,053)**	(251,863)	**(600,290)**	(547,966)
Salaries and fringe benefits	**2,523,096**	2,209,401	**4,984,739**	4,255,267
Subcontractors and professional fees	**618,275**	452,204	**1,105,703**	1,313,985
Rent, electricity , insurance and office expenses	**372,247**	335,111	**737,560**	665,222
Telecommunications and travel expenses	**318,899**	283,317	**570,399**	567,260
Bad debt expenses	**46,296**	23,232	**49,695**	25,773
Other expenses	**344,391**	411,687	**700,456**	727,968
Total cost of goods sold, operating, selling, administrative and research and development expenses	**8,870,501**	8,855,699	**17,151,454**	18,218,211

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 six-month periods ended December 31, 2013 and 2012; 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)

Depreciation by function	Three-month periods ended December 31, 2013	2012	Six-month periods ended December 31, 2013	2012
	$	$	**$**	$
Cost of goods sold	**38,616**	30,402	**80,226**	60,999
Operating expenses	**876**	991	**1,785**	1,942
Selling expenses	**8,838**	11,663	**19,670**	23,352
Administrative expenses	**19,008**	25,767	**38,065**	51,014
	67,338	68,823	**139,746**	137,307

Amortization by function	Three-month periods ended December 31, 2013	2012	Six-month periods ended December 31, 2013	2012
	$	$	**$**	$
Cost of goods sold	**92,128**	87,097	**183,306**	174,545
Selling expenses	**81,140**	78,070	**162,293**	156,444
Administrative expenses	**13,871**	12,770	**27,926**	24,706
	187,139	177,937	**373,525**	355,695

Cost per function including depreciation and amortization of intangible assets	Three-month periods ended December 31, 2013	2012	Six-month periods ended December 31, 2013	2012
	$	$	**$**	$
Cost of goods sold	**6,619,265**	7,075,346	**12,921,281**	14,713,714
Operating expenses	**219,520**	140,360	**403,015**	277,083
Selling expenses	**1,041,220**	994,363	**2,099,874**	1,927,580
Administrative expenses	**1,140,929**	892,390	**2,093,104**	1,792,836
Research and development expenses – net	**104,044**	-	**147,451**	-

c) Research and development expenses – net

	Three-month periods ended December 31, 2013	2012	Six-month periods ended December 31, 2013	2012
	$	$	**$**	$
Gross research and development expenses	**122,174**	-	**183,125**	-
Research and development tax credits and grants	**(18,130)**	-	**(35,674)**	-
	104,044	-	**147,451**	-

d) Other (gains) losses – net

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Exchange (gain) loss	**29,322**	26,484	**3,179**	(51,455)
Other (revenues) charges	**(9,794)**	(2,749)	**(17,404)**	(7,081)
Gain on disposal of property, plant and equipment	**-**	-	**(1,000)**	-
	19,528	23,735	**(15,225)**	(58,536)

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 December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
Net earnings (loss)	**($500,581)**	$488,854	**($970,575)**	$758,550
Basic and diluted weighted average number of share outstanding	**80,439,489**	60,145,832	**69,965,781**	60,145,832
Basic and diluted net earnings (loss) per share	**($0.006)**	$0.008	**($0.014)**	$0.013
Items excluded from the calculation of diluted net earnings (loss) per share because the exercise price was greater than the average market price of the common shares 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 six-month periods ended December 31, 2013 and 2012, the diluted net earnings (loss) per share was the same as the basic net earnings (loss) per share, since the effect of the assumed exercise of stock options and warrants to purchase common share is anti-dilutive. Accordingly, the diluted net earnings (loss) per share for these periods was calculated using the basic weighted average number of shares outstanding.

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 December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Accounts receivable	**(2,105,530)**	820,186	**(2,410,717)**	1,978,433
Inventories	**(428,432)**	(198,516)	**(720,899)**	(700,854)
Costs incurred in excess of billings	**1,254,161**	(53,417)	**714,297**	159,959
Prepaid expenses	**11,242**	307	**34,071**	36,758
Accounts payable and accrued liabilities	**(499,991)**	(825,939)	**489,767**	(981,675)
Provisions	**46,102**	4,970	**46,264**	20,906
Billings in excess of costs incurred	**(1,204,976)**	715,742	**(658,788)**	437,800
	(2,927,424)	463,333	**(2,506,005)**	951,327

b) Cash and cash equivalents consist of the following:

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Beginning of period				
Cash and cash equivalents	**137,613**	924,744	**303,936**	576,542
Bank overdraft	**(162,912)**	(216,719)	**(256,701)**	(155,210)
	(25,299)	708,025	**47,235**	421,332

	Three-month periods ended December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
End of period				
Cash and cash equivalents	**385,304**	839,111	**385,304**	839,111
Bank overdraft	**(174,864)**	(156,388)	**(174,864)**	(156,388)
	210,440	682,723	**210,440**	682,723

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 December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Revenues from sales of consumables	**4,116,954**	3,442,474	**7,329,128**	6,385,109
Manufacturing contracts revenues	**4,680,474**	5,976,434	**9,779,519**	13,016,693
	8,797,428	9,418,908	**17,108,647**	19,401,802

Geographical information

	Three-month periods ended December 31,		Six-month periods ended December 31,	
Revenue from external customers	**2013**	2012	**2013**	2012
	$	$	**$**	$
Revenue according to geographic location				
Canada	**3,464,765**	4,331,372	**6,626,171**	9,572,915
United States	**4,736,526**	3,978,733	**9,138,860**	8,082,351
China	**315,540**	593,009	**722,361**	992,267
Switzerland	**42,069**	-	**165,142**	-
Australia	**40,996**	-	**40,996**	-
Tunisia	**-**	339,795	**49,600**	339,795
Egypt	**-**	26,807	**-**	94,648
Other	**197,532**	149,192	**365,517**	319,826
	8,797,428	9,418,908	**17,108,647**	19,401,802

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

	As at December 31, 2013	As at June 30, 2013
	$	$
Non-current assets other than financial instruments and deferred tax assets according to geographic location		
Canada	**1,617,810**	1,693,898
United States	**10,951,860**	7,593,056
	12,569,670	9,286,954

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 December 31,		Six-month periods ended December 31,	
	2013	2012	**2013**	2012
	$	$	**$**	$
Short-term benefits	**438,461**	219,921	**713,250**	454,471
Post-employment benefits	**2,706**	2,400	**5,498**	5,008
Share-based payments	**2,155**	7,924	**7,806**	21,442
	443,322	230,245	**726,554**	480,921

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
Computershare Investor Services Inc.

Head Office
330, rue St-Vallier Est, Suite 340
Quebec City, Quebec, G1K 9C5
Phone: 418.688.0170
Fax: 418.688.9259

investor@h2oinnovation.com
www.h2oinnovation.com

Plants (North America)
201, 1st Avenue
Ham-Nord, Quebec G0P 1A0

1048 La Mirada Court
Vista, California 92081

8900, 109th Ave N, Suite 1000
Champlin, Minnesota 553160

Sales and Engineering Offices
1046, 18th Ave SE
Calgary, Alberta T2G 1L6

5100, South Service Road, Unit 17
Burlington, Ontario L7L 6A5