BULLIT

NxtGen Emission Controls Inc.

(a development stage company)

Consolidated Financial Statements

December 31, 2010

(expressed in Canadian dollars)

NxtGen Emission Controls Inc.

(a development stage company)
Consolidated Balance Sheet
As at December 31, 2010

(expressed in Canadian dollars)

	2010 $	2009 $
Assets		
Current assets		
Cash and cash equivalents	1,135,670	3,106,794
Accounts receivable and other	21,661	64,794
Government assistance receivable (note 3)	110,739	53,320
Investment tax credits receivable (note 12)	325,000	1,300,000
Deposits and prepaid expenses	74,273	109,648
Inventory	130,818	140,425
	1,798,161	4,774,981
Property and equipment (note 4)	1,768,166	1,565,670
	3,566,327	6,340,651
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	412,753	662,178
Current portion of bank loan (note 7)	416,495	282,775
	829,248	944,953
Bank loan (note 7)	312,147	376,706
Loan (note 10)	2,475,000	1,575,000
Asset retirement obligation	40,000	40,000
Preferred shares - liability component (note 6(c) and (d))	20,979,186	18,242,808
	24,635,581	21,179,467
Shareholders' Deficiency		
Preferred shares (note 6(c) and (d))	7,725,565	7,725,565
Common shares (note 6(b))	1,982,632	1,982,632
Warrants (note 6(g))	43,972	43,972
Contributed surplus (note 6(h))	3,441,692	2,912,743
Deficit	(34,263,115)	(27,503,728)
	(21,069,254)	(14,838,816)
	3,556,327	6,340,651

Nature of operations and going concern (note 1)

Commitment (note 16)

Subsequent event (note 17)

Approved by the Board of Directors

______________________________ Director　　______________________________ Director

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

BULLIT

NxtGen Emission Controls Inc.

(a development stage company)

Consolidated Statement of Operations, Comprehensive Loss and Deficit

For the year ended December 31, 2010

(expressed in Canadian dollars)

	2010 $	2009 $
Sales revenue	157,538	74,303
Cost of goods sold	74,738	48,600
Gross margin	82,800	25,703
Expenses		
Research and development	2,911,721	3,469,327
Government assistance (note 14)	(1,993,627)	(1,742,861)
Manufacturing - non-recoverable	547,165	389,275
Stock based compensation (note 6(f))	528,949	812,425
General, sales and administration	1,759,449	2,584,966
Amortization expense - property and equipment	337,214	250,413
	4,090,871	5,763,545
Loss before other items	(4,008,071)	(5,737,842)
Other items		
Interest and other income	12,040	106,254
Accretion expense - preferred shares	(2,736,378)	(2,379,458)
Foreign exchange loss	(26,978)	(122,624)
	(2,751,316)	(2,395,828)
Loss and comprehensive loss for the year	(6,759,387)	(8,133,670)
Deficit - Beginning of year	(27,503,728)	(19,370,058)
Deficit - End of year	(34,263,115)	(27,503,728)

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

NxtGen Emission Controls Inc.

(a development stage company)
Consolidated Statement of Cash Flows
For the year ended December 31, 2010

(expressed in Canadian dollars)

	2010 $	2009 $
Cash flows from operating activities		
Loss and comprehensive loss for the year	(6,759,387)	(8,133,670)
Items not affecting cash		
Amortization of property and equipment	337,214	250,413
Accretion expense - preferred shares	2,736,378	2,379,458
Stock-based compensation	528,949	812,425
Warrants issuance cost (note 6(g))	-	43,972
	(3,156,846)	(4,647,402)
Change in non-cash working capital (note 15)	756,273	(466,731)
	(2,400,573)	(5,114,133)
Cash flows from investing activities		
Purchases of property and equipment	(539,710)	(766,644)
Cash flows from financing activities		
Proceeds from bank loan (note 7)	412,312	594,798
Repayment of bank loan	(343,152)	(129,364)
Proceeds from loan	900,000	-
Issuance of common shares on exercise of options (note 6(b) and (f))	-	20,825
Repayment of obligations under capital lease	-	(13,388)
	969,160	472,871
(Decrease) increase in cash and cash equivalents	(1,971,123)	(5,407,906)
Cash and cash equivalents - Beginning of year	3,106,794	8,514,700
Cash and cash equivalents - End of year	1,135,670	3,106,794

Supplemental cash flow information (note 16)

1 Nature of operations and going concern

NxtGen Emission Controls Inc. (the “company”) was incorporated under the laws of the Province of British Columbia on February 20, 2004. The company is engaged in the research and development and manufacturing of syngas systems with products for diesel retrofit emission system manufacturers, Tier 1 system integrators, diesel and gasoline engine manufacturers.

Going concern

While the accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and liquidation of liabilities during the normal course of operations, there are conditions that cast doubt upon the validity of this assumption. The company has not yet realized profitable operations, generated consistent sales revenue or positive cash flows from operating activities. At December 31, 2010 the company has a net working capital of $968,913, and a shareholders’ deficiency of $21,069,254. The company has relied on external sources of debt and equity and government assistance to fund operations to date.

The material uncertainties that cast significant doubt about the company’s ability to continue as a going concern are described below.

The company is in the development stage and planning for production in early 2011. Delays or increased costs in product development, customer development, product approval of the company’s retrofit product by the US Environmental Protection Agency (EPA) and the start up of the production facility would result in the need for further financing. The company is also reliant on government assistance (note 3), a loan agreement with Cenovus Energy Inc. (note 10) and refundable Scientific Research and Experimental Development (“SR&ED”) investment tax credits (note 12). Delays or failure to achieve the milestone related to additional government assistance and the next loan payment from Cenovus Energy Inc. could result in the need for further financing before the end of 2011.

The company’s ability to continue as a going concern will depend on management’s ability to successfully complete development, achieve EPA approval, start production and meet milestones to obtain continued funding assistance. Additionally, the company may be affected by acceptance of its products. The company will seek additional forms of debt or equity financing, and government assistance but cannot provide assurance that it will be successful. These financial statements do not include adjustments or disclosures that may result from the company’s inability to continue as a going concern.

If the going concern assumption is not appropriate for these financial statements, then adjustments would be necessary in the carrying value of assets and liabilities, and the reported net losses and balance sheet classifications used. Such adjustments could be material.

2 Summary of significant accounting policies

Basis of consolidation

These consolidated financial statements are prepared in accordance with generally accepted accounting principles ("GAAP") in Canada, and include the accounts of the Company and its wholly-owned subsidiary, NxtGen Emission Controls USA Inc. All material intercompany balances and transactions are eliminated upon consolidation.

Reporting currency and foreign currency translation

These consolidated financial statements are reported in Canadian dollars. Foreign currency denominated revenues and expenses are translated using average rates of exchange during the year. Foreign currency denominated assets and liabilities are translated at the rate of exchange in effect at the balance sheet date. The resulting exchange gains and losses are recognized in the statement of operations.

The company's subsidiary is considered to be an integrated operation. For integrated foreign operations, monetary items are translated at the exchange rates prevailing at the balance sheet date; non-monetary items are translated at the historical exchange rate; and revenue and expenses are translated using the average rates for the period, except for amortization which is translated at the historical exchange rates. Translation gains and losses are included in the statement of operations.

Cash and cash equivalents

Cash and cash equivalents include cash on hand, bank balances, and short-term liquid investments with maturities of three months or less.

Inventories

Section 3031 establishes standards for the measurement of inventory at the lower of cost and net realizable value; the cost of inventory includes costs directly attributable to its acquisition as well as an appropriate portion of fixed and variable production overheads; if the units in inventory are interchangeable, their cost should be determined using either a first-in first-out or weighted average cost formula; and write downs of inventory to its net realizable value should be reversed if the value subsequently recovers.

Inventories are recorded at the lower of cost and net realizable value. Costs of raw materials are determined using first-in first-out method. Management ascertains that the adoption of this Handbook Section effective January 1, 2008 had no impact on the company's consolidated financial statements.

Note: discuss switch to FIFO from weighted avg. No material impact. Note disclosure required if immaterial?.

Property and equipment

Property and equipment are recorded at cost. The company capitalizes costs related to assets under construction. Amortization of assets under construction - engineering and manufacturing equipment commences in the year which the assets are brought into use. Engineering and manufacturing equipment and motor vehicles are amortized on a straight-line basis as follows:

Engineering and manufacturing equipment	7 years
Motor vehicles - test platform	3 years

Furniture and fixtures, computer equipment and existing software are amortized at the following rates on a declining balance basis:

Computer equipment	30%
Computer software	100%
Furniture and fixtures	30%

Effective 2010 the company capitalized newly purchased computer software as Intangible Assets, amortized on a straight-line basis over 3 useful years.

Leasehold improvements are amortized on a straight line basis over the life of the lease.

The company evaluates the carrying value of its equipment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The company recognizes an impairment loss when the estimated future undiscounted cash flows of the underlying asset are less than the carrying value of that asset. If an impairment is determined, assets are written down to their fair value.

Asset retirement obligation

The company has reserved an amount for restoration of leasehold improvements at the company’s Richmond facility, due at the end of the lease term in June 2014.

Patent costs

Patent application costs are expensed in the period in which they are incurred. These costs include legal and other fees associated with patent applications in domestic and international jurisdictions.

Intangible assets

Intangible assets represent computer software acquired since 2010 and intellectual property acquired in 2004. The recoverability of the intangible assets is assessed whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The company recognizes an impairment loss when the estimated future undiscounted cash flows of the underlying intangible asset are less than the carrying value of that intangible asset. If an impairment is determined, assets are written down to their fair value.

Beginning in 2006, the company started amortizing the intellectual property over a three-year period on a straight-line basis. As of December 31, 2008, the intellectual property was fully amortized.

Government assistance and investment tax credits

The company periodically applies for financial assistance under available government incentive programs. The company recognizes government assistance and investment tax credits for qualifying research and development costs when there is reasonable assurance the government assistance and investment tax credit will be realized. Government assistance relating to research grants for operating expenses is recorded as a reduction of related expenses or as a reduction of property and equipment for eligible capital expenditures in the period when the qualifying expenditures have been incurred and receipt of such assistance is reasonably assured. Government assistance relating to refundable investment tax credits resulting from research and development expenditures is recorded as a reduction of related expenses.

Amounts recorded as investment tax credits receivable are subject to audit by the Canada Revenue Agency ("CRA") and reflect management's best estimate of the recoverable amounts in light of CRA's current practice.

Revenue recognition

The company's revenues to date have been generated from the sale and rental of prototype and evaluation syngas generators as well as the sale of commercial syngas systems to its retrofit channel partner, Engine Control Systems, Inc, for use in achieving US Environmental Protection Agency approval.

The company recognizes revenue on the sale and rental of syngas generators and systems when persuasive evidence of an arrangement exists, the sales price is fixed or determinable, title and risk of loss has passed to the customer, collectability of the resulting receivable is reasonably assured and the rights and risks of ownership have passed to the customer. Cash received in advance of revenues being recognized on lease contracts for evaluation units is classified as deferred revenue.

Research and development costs

Research costs are expensed as incurred. In accordance with CICA Handbook Section 3064, to date development costs have been expensed as incurred.

Preferred shares

The Series A-1 and B-1 retractable and convertible preferred shares on initial recognition were split between their liability and equity component. The retraction premium, equal to the excess of the retraction amount over the carrying value initially assigned to the debt component is accreted over the retraction term. The premium is treated as an interest accretion charged to the statement of operations.

Stock-based compensation

The company accounts for grants under its stock option plan using the fair value-based method of accounting for stock-based compensation. Fair values are determined using the Black-Scholes option pricing model. Since 2009, the company has included a forfeiture factor to the model. Compensation costs are recognized upon vesting as an increase to stock-based compensation expense and contributed surplus. If and when stock options are ultimately exercised, the applicable amounts of additional cash received and contributed surplus are transferred to share capital. For options granted to non-employees, the fair value is measured when performance is complete, a performance commitment is made or options are fully vested and non-forfeitable, whichever is earliest, and the expense is recognized over the period in which the goods or services from the non-employees are received. The effects of forfeitures are accounted for as they occur.

Income taxes

The company accounts for income taxes using the liability method, whereby future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities. These differences are measured using substantially enacted tax rates and laws that will be in effect when the differences are expected to reverse. Future tax assets, including the benefit of income tax losses available for carry-forward, are only recognized to the extent that it is more likely than not that the company will ultimately realize those assets.

Financial instruments and comprehensive income

Recognition and measurement

The company adopted the CICA Handbook Sections 3855, *Financial Instruments - Recognition and Measurement*, 3861, *Financial Instruments - Disclosure and Presentation*, 3865, *Hedges*, 1530, *Comprehensive Income*, and 3251, *Equity* for financial instruments.

Section 3855 establishes standards for the recognition and measurement of all financial instruments, provides a characteristics-based definition of a derivative financial instrument, provides criteria to be used to determine when a financial instrument should be recognized, and provides criteria to be used when a financial instrument is to be extinguished. Under this standard, all financial instruments are required to be measured at fair value on initial recognition. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, held-to-maturity, available-for-sale, loans and receivables, or other financial liabilities. The company has implemented the following classifications for its financial instruments:

a) Cash and cash equivalents are classified as “assets held for trading” and are measured at fair value at the end of each period with any resulting gains or losses recognized in operations.

b) Cash and cash equivalents are classified as “assets held for trading” and are measured at fair value at the end of each period with any resulting gains or losses recognized in operations.

c) The company’s government assistance receivable has been classified as “loans and receivables” and is measured at amortized costs, using the effective interest rate method.

d) Loan payable, including accrued interest is classified as a financial liability and is measured at amortized cost, using the effective interest rate method.

Derivative financial instruments and embedded derivatives

In accordance with Section 3855, the company classifies derivative financial instruments that have not been designated as hedges for accounting purposes and embedded derivatives as held-for-trading, and values them at fair value each period with changes recorded in operations.

Comprehensive income

Section 1530 establishes standards for reporting and displaying comprehensive income. Comprehensive income is defined as the change in equity (net assets) from transactions and other events from non-owner sources. Other comprehensive income is defined as revenues, expenses, gains and losses that, in accordance with primary sources of GAAP, are recognized in comprehensive income, but excluded from net income. No other comprehensive income was recorded by the company during the year.

Financing charges

Financing charges that reflect the cost to obtain new debt financing are expensed as incurred. Financing charges that reflect the cost to obtain new equity financing are deducted from net proceeds.

Disclosure and Presentation

On January 1, 2008, the company adopted CICA Handbook Section 3862, *Financial Instruments - Disclosures* and Section 3863, *Financial Instruments - Presentation*.

Section 3862 requires disclosure about the significance of financial instruments for an entity’s financial position, the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks.

Section 3863 establishes standards for presentation of financial instruments and non-financial derivatives.

Sections 3862 and 3863 replace Section 3861, *Financial Instruments - Disclosure and Presentation*.

Capital Disclosures

Effective January 1, 2008, the Company adopted the new recommendations of the CICA Handbook Section 1535, *Capital Disclosures*. Section 1535 establishes standards for disclosing information about an entity’s capital and how it is managed to enable users of its financial statements to evaluate the entity’s objectives, policies and processes for managing capital. These new standards relate only to disclosure and presentation and have no impact on the company's results. Refer to note 9 for additional disclosures related to capital management.

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during this reporting period. Significant areas requiring the use of management estimates include the determination of the net recoverable amount of property and equipment and intangible assets, the determination of the amortization period for property and equipment, the estimated amount of accrued liabilities, and the realization of future tax assets, the liability component of preferred shares, determination of fair value of shares and stock-based compensation expense. Actual results could differ from such estimates.

Recent Canadian GAAP announcements

The CICA has issued new standards which may affect the financial disclosures and results of operations of the company for interim and annual periods beginning January 1, 2009. The company will adopt the requirements commencing in the year ended December 31, 2009. The new standards are described below:

Section 3064, Deferral of Costs and Internally Developed Intangibles

In November 2007, the Accounting Standards Board (AcSB) approved Section 3064, *Goodwill and Intangible Assets*, replacing Section 3062, *Goodwill and Other Intangible Assets*, and Section 3450, *Research and Development Costs* effective for fiscal years beginning on or after October 1, 2008. Section 3064 addresses when an internally developed intangible asset meets the criteria for recognition as an asset.

Management has concluded that this standard does not impact the company's consolidated financial statements.

Sections 1582, Business Combinations, 1601, Consolidated Financial Statements, and 1602, Non-controlling Interests

In January 2008, the CICA issued Handbook Sections 1582, *Business Combinations*; 1601, *Consolidated Financial Statements* and 1602, *Non-Controlling Interests.* These sections replace the former CICA Handbook Section 1581, *Business Combinations* and Section 1600, *Consolidated Financial Statements* and establish a new section for accounting for a non-controlling interest in a subsidiary. These sections also provide the Canadian equivalent to International Financial Reporting Standards ("IFRS") 3, *Business Combinations* and International Accounting Standards ("IAS") 27, *Consolidated and Separate Financial Statements*.

Section 1582 is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Sections 1601 and 1602 apply to interim and annual consolidated financial statements relating to years beginning on or after January 1, 2011.

Management has concluded that these standards do not currently impact the company's consolidated financial statements.

Section 1506, Accounting Changes, Section 1625, Comprehensive Revaluation of Assets and Liabilities, Section 3251, Equity and Section 3855, Financial Instruments

In October 2009, the CICA amended Handbook Section 1506, *Accounting Changes*, Section 1625, *Comprehensive Revaluation of Assets and Liabilities*, Section 3251, *Equity* and Section 3855, *Financial Instruments*. Section1506 was amended to exclude from its scope changes in accounting policies upon the complete replacement of an entity's primary basis of accounting and apply to interim and annual financial statements relating to years beginning on/after July 1, 2009. Section 1625 has been amended as a result of issuing Sections 1582, 1601, and 1602 described above and effective prospectively for comprehensive revaluations of assets and liabilities occurring in years beginning on/after January 1, 2011. Section 3251 has been amended as a result of issuing Section 1602 and apply to entities that have adopted Section 1602. Section 3855 amended to clarify when an embedded prepayment option is separated from its host debt instrument for accounting purposes. Amendments apply to interim and annual financial statements relating to years beginning on/after January 1, 2011.

Management is currently in the process of determining the impact of these standards on the company's consolidated financial statements.

EIC 173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities

In November 2009, the CICA Emerging Issues Committee approved the Basis of Application of EIC 173, *Credit Risk and the Fair Value of Financial Assets and Financial Liabilities* to apply to interim and annual financial statements for periods ending on or after January 20, 2009, except for entities that do not apply Section 3855 who may defer application to interim and annual financial statements relating to years beginning on or after January 1, 2010.

Management is currently in the process of determining the impact of this basis of application on the company's consolidated financial statements.

Comparative amounts

Comparative amounts have been reclassified, where necessary, to conform to the financial statement presentation adopted in the current year.

3 Government assistance receivable

From time to time, the company has entered into agreements under the Industrial Research and Assistance Program ("IRAP") with the National Research Council ("NRC") to provide funding support for the design, building, and demonstration of the company's syngas generator systems.

Under the terms of the 2010 agreements, the NRC agreed to contribute up to a maximum of $764,488 for costs incurred and paid in the direct performance of the work undertaken by the company. IRAP grants received are non-repayable. During 2010, $411,380 (2009 - $96,652) was received and $110,739 (2009 - $53,320) remained receivable at December 31, 2010.

Sustainable Development Technology Canada (SDTC) agreement

On November 1, 2007, the company entered into a contribution agreement with SDTC, a foundation created by the government of Canada to support the development and demonstration of clean technologies. Financial assistance will be provided to fund eligible costs for a project entitled “Mobile Diesel Emission Reduction System Field Trials and Performance Verification” to develop and demonstrate the technology that significantly reduces nitrogen oxide (NOx) and particulate matter emissions from diesel engines while enabling increased fuel economy.

Under the terms of the agreement, SDTC shall pay the lesser of 29.7% of eligible project costs incurred after October 31, 2007 or $2,516,882.

Payments will be made based on milestones set out in the agreement. The first and second payments for $1,132,596 are payable in advance of work performed and the final payment of $251,688 is due upon successful completion of the project. The first payment of $1,132,596 was received during January 2008. Of this amount, $81,026 (2009 - $230,929) has been recorded as a liability as it is eligible for repayment to a SDTC Consortium member for their contribution to the first milestone and contingent on the Consortium member performing its services. The second payment of $1,132,596 was received in November 2010.

4 Property and equipment

			2010
	Cost $	**Accumulated amortization** $	**Net** $
Computer equipment	219,027	128,763	90,263
Computer software	79,275	78,678	597
Furniture and fixtures	80,991	37,306	43,684
Equipment and machinery	2,190,334	729,872	1,460,462
Motor vehicles - test platform	45,639	27,671	17,967
Leasehold improvement	163,250	33,132	130,118
	2,778,515	1,035,424	1,743,091

	2009		
	Cost **$**	**Accumulated amortization** **$**	**Net** **$**
Computer equipment	181,365	98,150	83,215
Computer software	78,079	65,734	12,345
Furniture and fixtures	74,369	25,398	48,971
Equipment and machinery	1,833,195	475,131	1,358,064
Motor vehicles - test platform	24,078	24,078	-
Leasehold improvement	77,808	14,733	63,075
	2,268,894	703,224	1,565,670

The company's Wixom facility started low volume production in July 2010 and the company commenced amortization of manufacturing and assembly equipment..

5 Intangible Assets

	2010		
	Cost **$**	**Accumulated amortization** **$**	**Net** **$**
Computer software and licenses	30,089	5,014	25,075
Intellectual property	50,000	50,000	-
	82,099	55,014	25,075

	2009		
	Cost **$**	**Accumulated amortization** **$**	**Net** **$**
Intellectual property	50,000	50,000	-
	50,000	50,000	-

New purchases of computer software are capitalized as intangible assets, and are amortized using straight-line method over 3 useful years.

6 Capital stock

October 10, 2008 Series B-1 Financing

On October 10, 2008, the company completed a Series B-1 Financing (see note 6(d)). The company issued 18,845,697 retractable Series B-1 Preferred shares for cash proceeds of $11,299,299.

In addition, the company issued 10,568,435 Series B-1 Preferred shares on conversion of $6,336,511 Convertible Notes and accrued interest.

As part of the Series B-1 Financing, the Series A Preferred shares, cumulative, retractable and without par value were modified to Series A-1 Preferred shares, retractable without par value. The modification (as described in note 6(c) resulted in the Series A-1 Preferred shares having equivalent features as the Series B-1 Preferred shares, which included ceasing cumulative dividends.

Prior to the October 10, 2008 modification, the company declared an 8% cumulative dividend totalling $1,445,751 payable to the Series A Preferred shares. These dividends were declared and paid October 10, 2008 by the issuance of 2,409,587 common shares based on a value of $0.60 per share.

a) Authorized

52,000,000 common shares, voting and without par value
9,435,837 Class A Preferred shares, which may be issued in one or more series, retractable and without par value, of which 9,435,837 Series A-1 are authorized
29,500,000 Class B Preferred shares, which may be issued in one or more series, retractable and without par value, of which 29,414,132 Series B-1 are authorized

b) Issued and outstanding

Common shares

	Number of shares	**Amount $**
Balance - December 31, 2008	6,225,587	1,944,377
Issued on exercise of stock options	208,250	38,255
Balance – December 31, 2009 and 2010	6,433,837	1,982,632

During 2010, the company issued Nil (2009 - 208,250) shares from the exercise of a former employee’s stock options.

c) Series A-1 Preferred shares

Issued and outstanding

The following table shows the liability and equity components of the preferred shares:

	Number of shares	Liability $	Equity component $	Total $
Balance - December 31, 2008	9,435,837	3,854,896	1,938,973	5,793,869
Accretion	-	578,234	-	578,234
Balance - December 31, 2009	9,435,837	4,433,130	1,938,973	6,372,103
Accretion	-	664,969	-	664,969
Balance - December 31, 2010	9,435,837	5,098,099	1,938,973	7,037,072

At October 10, 2008, as part of the Series B financing, Series A Preferred shares were modified in accordance with the equivalent features of Series B-1 Preferred shares. The amended changes are as follows:

i) the Series A Preferred shares were changed to Series A-1 Preferred shares;

ii) the retraction date was modified to allow holders of Series A-1 Preferred shares to exercise their retraction right at any time after October 10, 2011 rather than October 6, 2010;

iii) the retraction price of $0.48 was modified to $0.60; and

iv) the cumulative dividends ceased.

In accordance with CICA Handbook Section 3855, the company revalued the Series A Preferred shares based on the modifications resulting from the October 10, 2008 financing. The company calculated a difference of $2,125,542 (the difference between the discounted value of the new Series A-1 Preferred shares and the carrying amount of the Series A Preferred shares) due to the modifications. As the modification of the Preferred shares involved certain related parties (by common directorship), $1,762,799 as contributed surplus for the related party portion and $362,743 was recorded as a gain in the statement of operations for the non-related party portion. As a result of the modification on the Series A Preferred shares, the equity component was subsequently increased by $567,824.

During 2010, $664,969 (2009 - $578,234) was recorded as accretion expense towards the carrying value of the total liability component, using the effective interest rate method at 15%.

d) Series B-1 Preferred shares

Issued and outstanding

The following table shows the liability and equity components of the preferred shares:

	Number of shares	Liability $	Equity component $	Total $
Balance - December 31, 2008	29,414,132	12,008,454	5,786,592	17,795,046
Accretion	-	1,801,224	-	1,801,224
Balance - December 31, 2009	29,414,132	13,809,678	5,786,592	19,596,270
Accretion	-	2,071,407	-	2,071,407
Balance - December 31, 2010	29,414,132	15,881,085	5,786,592	21.667.677

On October 10, 2008, the Company issued Series B-1 Preferred shares for cash and for conversion of Convertible Notes and accrued interest. For shares issued for cash, $7,429,473 was recorded as the liability component and a total residual value of $3,869,826 was recorded as the equity component, before $645,898 of share issuance costs ($392,512 was recorded as an expense in the statement of operations and $253,386 was recorded against the equity component of the Series B-1 Preferred shares).

For shares issued on the conversion of convertible notes and accrued interest, a total value of $4,166,359 was recorded as the liability component and a total residual value of $2,170,152 was recorded as the equity component.

During 2010, $2,071,407 (2009 - $1,801,224) was recorded as accretion expense towards the carrying value of the total liability component, using the effective interest rate method at 15%.

e) Series A-1 and Series B-1 Preferred shares features

Series A-1 and B-1 Preferred shares have the following retraction and conversion rights:

Retraction right

Holders of Series A-1 and B-1 Preferred shares have the right, at any time after October 10, 2011 (the third anniversary of the Initial B-1 Issuance Date), to require the company to redeem all, but not less than all, Series A-1 or B-1 Preferred shares at a price equal to the greater of:

i) the issue price plus all declared but unpaid dividends on such Series A-1 or B-1 Preferred shares, and

ii) the fair market value of the Series A-1 or B-1 Preferred shares as if the preferred shares had been converted into common shares.

The issue price of Series A-1 and B-1 Preferred shares for the retraction right are $0.60 and $0.522 US respectively.

Voluntary conversion

i) Holders of Series A-1 or B-1 Preferred shares are entitled at any time to have all or any of the Series A-1 or B-1 Preferred shares converted into common shares on the basis of one common share for one Preferred share.

Automatic conversion

All of the Series A-1 or B-1 Preferred shares are automatically converted into common shares, at the then applicable conversion rate, in the event of:

i) the election of holders of 50% of the outstanding combined Series A-1 and B-1 Preferred shares to vote together as a class;

ii) the prior conversion of not less than 50% of the shares of the combined Series A-1 and B-1 Preferred shares into common shares;

iii) the closing of an initial public offering of the common shares under a prospectus or registration statement filed with securities regulatory authorities in Canada or in the United States, raising aggregate net proceeds of at least US$30 million at a minimum share price of at least six times the Series A-1 and B-1 Preferred share issue price, as adjusted for any stock split or consolidation or other such capital reorganization, and having such common shares listed on a senior stock exchange; or

iv) the company entering into a transaction resulting in the sale of all of the issued and outstanding shares of the company or all or substantially all of the assets of the company, where the proceeds from such sale paid to or distributed to the shareholders of the company will result in the shareholders receiving cash or readily liquid securities having a value of at least six times the Series A-1 and B-1 Preferred share issue price, as adjusted for any stock split or consolidation or other such capital reorganization.

While the legal form of the financial instrument is that of preferred shares, for accounting purposes, they are considered to have both a liability and equity component. The liability component which results from the holder’s retraction right has been recorded at its fair value, using a discounted future cash flow with a discount rate of 15%, on the date of issuance of the preferred shares. The equity component is related to the conversion feature of the instrument, calculated using the residual value method. The carrying value assigned to the liability portion of preferred shares is being accreted to the maturity value over the period from the date of issuance to their final retraction date.

f) Stock options

The company amended and restated the 2005 Stock Option Plan in October 2008 to provide for the granting of incentive stock options for up to 6,694,845 (2009 - 6,694,845) of the company's common shares. The options entitle directors, officers, employees and consultants to purchase common shares of the company. The Board of Directors can grant options with terms of up to 10 years. The exercise price and vesting period for an option is determined by the Board of Directors and is detailed in the notice of grant issued in respect of each option. The exercise price shall not be less than $0.10 per share. The Board of Directors may elect, at any time, to accelerate the vesting schedule of one or more option grants.

Activity under the Plan is as follows:

	Number of options	**Weighted average exercise price $**
Balance - December 31, 2008	5,976,006	0.45
Exercised in 2009	(208,250)	0.10
Granted in 2009	245,000	0.60
Forfeited in 2009	(154,250)	0.49
Balance - December 31, 2009	5,858,506	0.47
Granted in 2010	10,000	0.60
Forfeited in 2010	(85,000)	0.60
Balance - December 31, 2010	5,783,506	0.47

As at December 31, 2010, the company has the following stock options outstanding:

	Options outstanding			**Options exercisable**		
Range of exercise price $	**Number of shares**	**Weighted average remaining contractual life (years)**	**Weighted average exercise price $**	**Number exercisable**	**Weighted average remaining contractual life (years)**	**Weighted average exercise price $**
0.10	1,130,000	4.55	0.10	1,130,000	4.55	0.10
0.48	1,673,095	6.26	0.48	1,370,236	6.62	0.48
0.60	2,980,411	7.96	0.60	1,954,392	7.89	0.60
	5,783,506	6.80	0.47	4,454,628	6.65	0.44

During 2010, 10,000 (2009 - 245,000) options were granted to employees of the company and nil (2009 - nil) options were granted to non-employees.

The weighted average fair value of options granted during the year ended December 31, 2010 was determined to be $0.60 per option (2009 - $0.60). This amount was calculated in accordance with the fair value method of accounting and was estimated on the grant date using the Black-Scholes option pricing model (assuming a risk-free interest rate of 4%; dividend yield of 0%; stock price volatility of 85%; and an expected life of options of 10 years).

During 2010, the company recorded $528,949 (2009 - $812,425) in stock-based compensation expense as granted options vested from the following departments:

	2010 **$**	**2009** **$**
Research and development	35,271	54,563
Manufacturing	18,431	16,068
General, sales and administration	475,247	741,794
	528,949	812,425

g) Warrants

On July 15, 2009, the company issued warrants to Comerica Bank as a fee for the First Amended and Restated Loan Agreement with Comerica Bank (see note 7). The warrants entitle the holder to purchase 94,666 common shares at an exercise price of $0.60 per share. The expiration date is July 15, 2016, unless the company completes an initial public offering before that date, at which time the expiration date will be the first anniversary of the effective date of the company's initial public offering. The warrants are valued at the fair value of $43,972, determined using the Black Scholes option pricing model and expensed as financing costs.

h) Contributed surplus

	$
Balance - December 31, 2008	2,117,747
Exercise of stock option	(17,429)
Stock-based compensation	812,425
Balance - December 31, 2009	2,912,743
Stock-based compensation	528,949
Balance - December 31, 2010	3,441,692

7 Bank loan

On December 7, 2006 (the "Original Closing Date"), the company entered into a loan agreement (the "Original Loan") with Comerica Bank (the "Bank") which provided a facility of up to $700,000 guaranteed by a general security agreement over all assets. The Original Loan bears interest on the daily balance at 1% above the Canadian prime rate per annum. Advances made during the period ending six months from the Original Closing Date are payable in 30 equal monthly instalments of principal, plus all accrued interest, beginning on April 30, 2007, and continuing on the same day of each month thereafter through September 30, 2009. Advances that are outstanding on the date twelve months from the Original Closing Date (which were advanced six months after the Original Closing Date) are payable in 30 equal monthly instalments of principal, plus all accrued interest, beginning on October 30, 2007, and continuing on the same day of each month thereafter through to June 7, 2010 at which time all amounts owing shall be immediately due and payable.

On July 15, 2009 (the "Closing Date"), the company amended and restated the terms and conditions of the Original Loan. Under the First Amended and Restated Loan Agreement (the "Amendment"), the balance of $129,364 from the Original Loan remained outstanding as Initial Equipment Advance (Tranche 1) (the "Tranche 1 Advance"). The loan bears interest on the daily balance at 1% above the Canadian prime rate per annum. The average interest rate applied for 2010 is 5.06%.

Additional advances under Equipment Advances (Tranche 2) (the "Tranche 2 Advance) and Equipment Advances (Tranche 3) (the "Tranche 3 Advance") were also included in the Amendment.

The Tranche 2 Advance provides a credit extension of US$1,000,000 for purchases made before July 15, 2010 provided that the aggregate advances related to invoices for the purchase and refurbishing of used manufacturing equipment for the facility located in Wixom, USA is limited to US$660,000. The Tranche 3 Advance provides a credit extension of $300,000. Both advances bear interest on the daily balance at 3.5% above the sum of the Daily Adjusting LIBOR Rate plus 2.5% per annum. If, at any time, the Bank determines that it is unable to determine or ascertain the Daily Adjusting LIBOR Rate for any day, the Prime Referenced Rate for each such day shall be the applicable Canadian prime rate in effect at such time but not less than 2.5% per annum. Advances made during the period ending six months from the Closing Date are payable in 30 equal monthly instalments of principal, plus all accrued interest thereon, beginning on February 1, 2010. Advances that are outstanding on the date twelve months from the Closing Date (which have not already begun amortizing) are payable in 30 equal monthly instalments of principal, plus all accrued interest beginning on August 1, 2010, and continuing on the same day of each month thereafter through January 2013 at which time all amounts shall be immediately due and payable. The average interest rate applied for Tranche 2 Advance is 6.75% and for Tranche 3 Advance is 6.10%.

As a fee for the Amendment, the Company issued warrants in 2009 entitling the Bank to purchase 94,666 warrants (see note 6(g)).

During 2010, the company was notified by Comerica Bank that the financial covenant of maintaining an Adjusted Quick Ratio of not less than 1.50:1.0, calculated at the end of each month, was violated for the period ending October 31, 2010. The company requested and Comerica Bank agreed to waive the breach of the financial covenant.

During 2009, the company was not in breach of any financial covenants.

As at December 31, 2010, the amounts of the facilities utilized were $323,411 for Tranche 1 Advance (2009 - $64,682), $715,776 (2009 - $423,951) for Tranche 2 Advance and $291.336 (2009 - 170,848) for Tranche 3 Advance; of this $393,744 (2009 - $282,775) is payable within 12 months. The available credit facility for Tranche 1 Advance is $nil (2009 - $nil), Tranche 2 Advance is $nil (2009 - $627,048) and Tranche 3 Advance is $nil (2009 - $129,152).

8 Financial instruments

The company, through its financial assets and liabilities identified in note 2, is exposed to a number of risks related to changes in foreign currency exchange rates, interest rates, settlement of liabilities and management of cash and cash equivalents as at December 31, 2010.

Credit risk exposure

Financial instruments that potentially subject the company to a significant concentration of credit risk consist primarily of cash and cash equivalents. The company aims to protect its cash and cash equivalents from undue risk by holding them with financial institutions with A credit ratings, located in Canada and the United States. The company's assessment of risk regarding the collection of qualifying investment tax credits is low.

Liquidity risk

Liquidity risk is the risk that the company will not be able to meet its financial obligations as they fall due. The following are the contractual maturities of financial liabilities and other obligations as at December 31, 2010:

	Total contractual cash flows $	**Due within one year $**	**2 to 3 years $**	**4 to 5 years $**
Financial liabilities and other obligations				
Accounts payable and accrued liabilities	412,753	412,753	-	-
Bank debt	728,642	416,495	312,147	-
Premise leases	940,674	222,841	589,265	128,568
Asset retirement obligation	40,000	-	-	40,000
	2,122,069	1,052,089	901,411	168,568

The company may be required to pay $ 20,932,767 if Preferred shareholders exercise their right to require the company to redeem all the Preferred shares (see note 6(b)).

In addition, as at December 31, 2010, the company has received $2,475,000 that is repayable under contingent terms (see note 10).

The company's objective to managing liquidity risk is to ensure that it has sufficient liquidity available to meet its liabilities when due. The company manages liquidity risk through arranging financing, utilizing budgets and cash flow forecasts, limiting expenditures, and the management of its cash and cash equivalents.

The company has relied on external sources of debt and equity to fund operations to date. The company's ability to continue as a going concern will depend on management's ability to successfully execute its business plan and obtain additional financing until it achieves profitability and positive cash flows from operating activities. The company may seek additional forms of debt or equity financing, but cannot provide assurance that it will be successful. See note 1 for further discussions regarding going concern.

Market risk

Market risk is the risk to the company that the fair value or future cash flows of financial instruments will fluctuate due to changes in interest rates and foreign currency exchange rates. Market risk arises as a result of the company incurring expenses in foreign currencies, holding cash and cash equivalents which earn interest, holding a loan with variable interest rates and having operations based in the United States in the form of its wholly owned subsidiary.

Interest rate risk

The only financial instruments that expose the company to interest rate risk are its cash and cash equivalents and its bank loans payable. The company's objectives of managing its cash and cash equivalents are to ensure sufficient funds are maintained on hand at all times to meet day-to-day requirements. The company's loan payable bears interest at rates based on the Canadian prime rate plus a premium of 1% and on the Daily adjusting LIBOR and/or the Canadian prime rate which cannot be less than 2.5% plus a premium of 2.5%. The company does not have in place any financial instruments to mitigate the possible adverse effects of an increase in the underlying Base Rate.

Currency risk

The company incurs expenditures primarily in Canada and the United States and is exposed to risk from changes in foreign currency rates. In addition, the company holds financial assets and liabilities in foreign currencies that expose the company to foreign exchange risks. The company has not utilized any financial instruments or cash management policies to mitigate the risks arising from changes in foreign currency rates, but plans to utilize forward exchange contracts when appropriate. At December 31, 2010, the company had cash and cash equivalents and other assets of $365,329, accounts and other payables of $99,330 and bank loan of $499,980 which were denominated in USD.

Sensitivity analysis

The company has completed a sensitivity analysis to estimate the impact on net loss for the period, which a change in foreign exchange rates or interest rates during the year ended December 31, 2009 would have had.

This sensitivity analysis includes the following assumptions:

a) changes in individual foreign exchange rates do not cause foreign exchange rates in other countries to alter, and

b) changes in market interest rates do not cause a change in foreign exchange rates.

The results of the foreign exchange rate sensitivity analysis can be seen in the following table:

		Impact on net loss $
Change of +/- 10% in the CA$ to US$ foreign exchange rate	+/-	229,000

The above results arise primarily as a result of the company having US$ denominated expenses.

Limitations of sensitivity analysis

The above table demonstrates the effect of either a change in foreign exchange rates or interest rates in isolation. In reality, there is a correlation between the two factors.

Additionally, the financial position of the company may vary at the time that a change in either of these factors occurs, causing the impact on the company's results to differ from that shown above.

9 Capital management

The company considers its share capital, contributed surplus, loans payable, warrants and preferred shares liability, as capital, which at December 31, 2010 totalled $37,376,689 (2009 - $33,142,201).

The company manages its capital structure in order to ensure sufficient resources are available to meet day to day operating requirements; to allow it to enhance existing product offerings as well as develop new ones and to have the financial ability to expand the size of its operations by taking on new customers. In managing its capital structure, the company takes into consideration various factors, including the regulations of the market in which it operates, the growth of its business and related infrastructure and the upfront cost of taking on new clients.

The company's officers and senior management take full responsibility for managing the company's capital and do so through monthly meetings and regular review of financial information. The company's Board of Directors are responsible for overseeing this process.

Methods used by the company to manage its capital include the issuance of new share capital which has historically been done through private placements primarily with institutional investors.

The company is not subject to any externally imposed capital requirements.

10 Loan

On November 29, 2007, the company entered into agreements with EnCana Corporation (EnCana) subsequently assigned to Cenovus Energy Inc. (Cenovus). Under the terms of the agreement, Cenovus will provide funding of up to $3 million towards the development, manufacture, marketing and sales of hydrocarbon fuel processors that produce syngas for use with compression and spark-ignited engines in after-treatment and combustion performance management systems to be used towards the projected total project cost of $16 million. Of these funds, $675,000 was received upon signing in 2007, $900,000 was received in 2008 upon achieving milestone one, and $900,000 was received in 2010 upon achieving milestone two. Funds received from Cenovus are classified as a liability as they are repayable due to the overriding annual royalty.

The company has granted an overriding annual royalty of 1% payable on the aggregate worldwide revenues of the company. In the event of a change of control of the company, Cenovus's royalty interest may be repurchased in full in an amount which is the greater of 1.25% of the fair market value of the company as defined or the total of all funding paid by Cenovus plus an amount equal to a 15% Rate of Return on such funding.

On December 1, 2009, Encana split into two independent companies and assigned the agreement to Cenovus Energy Inc., one of the successor companies. All terms and conditions remain unchanged.

On January 26, 2011, the company amended the agreement with Cenovus Energy Inc. by revising the milestones to be achieved, which triggered a $300,000 financing receivable from the completion of Milestone 2. The $300,000 was received in February 2011. (see note 17 subsequent event.)

11 Income taxes

The company has non-capital losses available for carry-forward in the amount of $12,764,976 to offset future taxable income. The company has SR&ED deductible expenditures available to offset against future taxable income in the amount of $7,119,726. These expenditures are carried forward indefinitely. No future benefit of the non-capital losses and deductible expenditures has been recorded in these financial statements.

	2010	2009
Combined Canadian federal and provincial income tax rates	14.9%	14.9%
Combined US federal and state income tax rates	37.0%	37.0%

	$	$
Canadian non-capital losses available for carry-forward		9,615,627
US non-capital losses available for carry-forward		3,149,349
	-	12,764,976

Canadian Non-capital losses incurred in taxation years ended on or prior to March 22, 2004 are carried-forward for seven years; losses incurred in taxation years ended after March 22, 2004 are carried forward for ten years. Losses incurred in 2006 are carried forward for 20 years (US Non-capital losses are carried forward for 20 years). The non-capital tax losses expire as follows:

	2010 $	2009 $
2011		91,004
2014		484,790
2026		1,798,373
2027		2,703,095
2028		3,860,534
2029		3,827,180
	-	12,764,976

Future income tax assets are as follows:

	2010 $	2009 $
Non-capital losses carry-forward		2,606,028
SR&ED deductible expenditures		1,078,044
Net book value in excess of tax value		(17,168)
	-	3,666,904
Valuation allowance		(3,666,904)
Future income tax assets	-	-

Management believes that there is sufficient uncertainty regarding the realization of future tax assets such that, a full valuation allowance has been provided.

12 Investment tax credits receivable

The company has filed for SR&ED deductible expenditures and investment tax credits as a result of incurring significant research and development costs. These deductible expenditures and tax credits are subject to CRA audit and verification.

During 2010, the company received SR&ED investment tax credits of $1,367,231 for 2009. The company has recorded $370,000 as SR&ED investment tax credits receivable related to its expenditures net of government assistance incurred in 2010.

13 Related party transactions

During 2009, the company provided a three-month, interest-free loan to the company's CEO in the amount of $15,310 which has been repaid in full as at December 31, 2009. The loan was provided for the payment of personal income taxes.

There were no related transactions in 2010.

14 Government assistance

	2010 **$**	**2009** **$**
Government assistance	(468,799)	(96,652)
SR&ED investment tax credit	(392,231)	(1,472,909)
SDTC	(1,132597)	(173,300)
	(1,993,627)	(1,742,861)

15 Supplemental cash flow information

a) Change in non-cash working capital

	2010 $	2009 $
Accounts receivable and other	43,133	(18,436)
Government assistance receivable	(57,419)	(53,320)
Investment tax credits receivable	975,000	500,000
Deposits and prepaid expenses	35,375	(53,057)
Inventory	9,607	(130,317)
Accounts payable and accrued liabilities	(249,424)	(690,758)
Deferred revenue	-	(20,843)
	756,273	(466,731)

b) Supplemental cash flow information

	2010 $	2009 $
Cash paid for interest	38,286	18,728
Cash received for interest	4,056	102,199
Equipment purchased through capital lease	-	13,388

16 Commitments

The sub-lease agreement for the old Burnaby, BC head office premises expired on December 31, 2009. On August 21, 2009, the company entered into a sub-lease agreement for the Richmond, BC premises for a period of 17 months commencing on February 1, 2010 (the “Commencement Date”). The agreement included a fixturing period for the two-month period prior to the Commencement Date. In addition, a free rent period applied for the months of April, May and December 2010, where no gross rent was paid. The company also signed a follow on three year lease from July, 2011 to January 30, 2014.

On February 7, 2008, the company entered into a lease agreement for the Wixom premises for a five-year period.

The annual lease commitments for the subsequent years are as follows:

	Wixom property lease $	Richmond property lease $	Total $
2011	69,224	153,617	22,841
2012	69,224	257,136	326,360
2013	5,769	257,136	262,905
2014	-	128,568	128,568
2015	-	-	-

17 Subsequent event

On January 26, 2011, the company amended the agreement with Cenovus Energy Inc. (see note 10) by revising the milestones to be achieved, which triggered a $300,000 financing receivable from the completion of Milestone 3. The $300,000 was received in February 2011 and added to the loan balance.

On January 7, 2011, the company signed a contract with Cummins Inc., for participation in the US Department of Energy (DOE) sponsored program, Advanced Technology Powertrains for Light Duty (ATP-LD) engines. The goal of the four year program is to accelerate the development of cost-competitive engine and powertrain systems for light-duty vehicles capable of attaining breakthrough thermal efficiencies while meeting future emissions standards. The ATP-LD program is funded at a 50% basis by the DOE. The contract provides for a $773,000 US cost recovery over the program. The company will be utilizing its syngas generators for thermal management of emission systmes and the reduction of nitrogen oxides. A $312,000 purchase order for the first year activities was issued to the company with the contract.