



Management Discussion and Analysis August 12, 2009

For the second quarter period ended June 30, 2009

This Management's Discussion and Analysis ("MD&A") should be read in conjunction with ProSep Inc.'s ("ProSep" or the "Company") Unaudited Interim Consolidated Financial Statements for the three month period ended June 30, 2009 and 2008 and should also be read with the Company's Annual Audited Consolidated Financial Statements and MD&A for the year ended December 31, 2008.

Regulatory Filings

The Company's continuous disclosure material including interim filings, annual MD&A and Audited Consolidated Financial Statements, Annual Information Form and Notice of Annual Shareholder Meeting and Proxy Circular are available at www.sedar.com and on the Company's website at www.prosepinc.com

Caution Regarding Forward-Looking Statements

This Management Discussion and Analysis may contain forward-looking statements, including statements regarding the business and anticipated financial performance of ProSep Inc. These statements are based, among others, on the Management's current assumptions, expectations, estimates, objectives, plans and intentions regarding projected revenues and expenses, the economic and industry environments in which the Company operates or which could affect its activities, the Company's ability to attract new clients and consumers as well as its operating costs, raw materials and energy supplies which are subject to a number of risks and uncertainties. Forward-looking statements can generally be identified by the use of the conditional tense, the words "may", "should", "would", "believe", "plan", "expect", "intend", "anticipate", "estimate", "foresee", "objective" or "continue" or the negative of these terms or variations of them or words and expressions of similar nature. Actual results could differ materially from the conclusion, forecast or projection stated in such forward-looking information. These statements are subject to a number of risks and uncertainties that may cause actual results to differ materially from those contemplated by the forward-looking statements. Some of the factors that could cause such differences include but are not limited to the Company's ability to develop, manufacture, and successfully commercialize value added equipments and services, the availability of funds and resources to continue its operations and pursue its projects, legislative or regulatory developments, competition, technological change, changes in government and economic policy, inflation and general economic conditions in geographic areas where ProSep Inc. operates. These and other factors should be considered carefully and undue reliance should not be placed on the forward-looking statements.

Use of estimates

In the course of the preparation of financial statements in conformity with Canadian generally accepted accounting principles, management must make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses for the period. Actual results could differ from these estimates.

All amounts are in Canadian Dollars unless otherwise specified

Non-GAAP Measurements

This MD&A contains the terms "cash flow before changes in non-cash working capital items", "earnings before interest, taxes, depreciation and amortization ("EBITDA") and "Net Unrestricted Working Capital" which should not be considered an alternative to or more meaningful than net earnings or cash flow from operating activities as determined in accordance with Canadian generally accepted accounting principles ("GAAP") as an indicator of the Company's performance. These terms do not have any standardized meaning as prescribed by GAAP. ProSep's determination of cash flow before changes in non-cash working capital items, EBITDA and Net Unrestricted Working Capital may not be comparative to that reported by other companies.

Management uses cash flow before changes in working capital items to analyze operating performance and leverage, and considers cash flow before changes in non-cash working capital items to be a key measure as it demonstrates the Company's ability to generate cash through the operations before working capital items. Cash flow before changes in working capital items is calculated using cash flow from operating activities as presented in the consolidated statement of cash flows before changes in working capital. The following table reconcile cash flow from operating activities and Cash flow form operating activities before changes in working capital items

	Three months ended		Six months ended	
	June 30,		June 30,	
	2009	2008	2009	2008
	\$	\$	\$	\$
Cash flow from operating activities	(3 707 142)	1 370 967	(3 960 362)	(1 536 741)
Changes in operating working capital items	(3 288 394)	1 283 296	(2 960 275)	(950 969)
Cash flow before changes in working capital items	(4 18 748)	87 671	(1 000 087)	(585 772)

Management also uses EBITDA, among other measures, to assess the operating performance of the ongoing businesses without the effects of depreciation expense. ProSep excludes depreciation expense because it largely depends on the accounting methods and assumptions a company uses, as well as on non-operating factors such as the historical cost of capital assets. The following table reconcile EBITDA with net profit.

	Six months ended June 30,		Three months ended June 30,	
	2009		2008	
	\$	\$	\$	\$
Net loss and comprehensive loss	(7,147,852)	(162,122)	(9,132,368)	(3,499,936)
Plus				
Future tax recovery	(111,945)	30,524	(28,372)	(50,618)
Current tax provision	145,752	564,859	185,085	770,027
Amortization	394,707	377,284	770,179	741,141
Financial charges	692,745	566,352	2,031,233	2,525,222
Decrease in fair value of ABCP	-	-	-	450,000
Impairment of goodwill	6,500,000	-	6,500,000	-
EBITDA	473,407	1,376,897	325,757	935,836

Net Unrestricted Working Capital is also used by management to analyze available liquidity and anticipated short term in/out flows and is defined as current assets, excluding restricted cash, less current liabilities excluding accrual related to restricted cash. The following table shows calculation of this non GAAP measure

	June 30, 2009	December 31, 2008
	\$	\$
Total current assets	25 000 236	30 213 779
less restricted cash	-	1 037 846
Sub total (a)	25 000 236	29 175 933
Total current liabilities	23 305 819	36 469 778
less accrual related to restricted cash	-	1 037 846
Sub total (b)	23 305 819	35 431 932
Net unrestricted working capital (a minus b)	1 694 417	(6 255 999)

Comparative figures

Comparative figures for the financial information related to the three and six month periods ended June 30, 2008 have been reclassified to conform with the June 30, 2009 presentation.

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1. OVERALL PERFORMANCE

1.1. Highlights of the Period Ended June 30, 2009 and Subsequent Events

- Subsequent to the quarter end, significantly strengthened balance sheet by converting \$8 million principal amount of indebtedness into equity and raising a potential maximum of \$10 million by way of a rights offering to shareholders, of which a minimum commitment of \$4.8 million from a group of debenture holders has been secured.
- Recorded revenues of \$9.3 million, a decrease of 38% from \$15.1 million during the corresponding period of 2008. Year-to-date, revenues are \$22.5 million, a 7% decrease from \$24.2 million during the corresponding period in 2008.
- Reported gross margin of \$3.7 million (40% of revenues) compared with \$4.2 million (28%) for the corresponding period of 2008. Year-to-date, gross margins stand at \$6.9 million (31%) compared with \$6.8 (28%) of revenues for the corresponding period of 2008.
- Generated EBITDA of \$0.5 million compared to \$1.4 million for the corresponding quarter of 2008. Year-to-date, EBITDA stands at \$0.3 million compared to \$0.9 million in 2008.
- Recorded a non-cash goodwill impairment of \$6.5 million as required under Canadian Generally Accepted Accounting Principles in light of recent decline in the Company's market capitalization and balance sheet restructuring initiative.
- Recorded net loss of \$7.1 million or \$0.11 per share compared with net loss of \$0.2 million for the corresponding period of 2008. Year-to-date, net loss was \$9.1 million or \$0.14 per share compared to \$3.5 million or \$0.06 per share for the corresponding period in 2008. Excluding goodwill impairment charge, non-GAAP adjusted net loss for the second quarter of 2009 was \$0.6 million and \$2.6 million for the six-month period, an improvement on a year-to-date basis.
- Successful commissioning of the Company's new 55,000 square foot assembly shop in Houston.
- Announced a \$1.4 million joint industry partnership with StatoilHydro, Total and Conoco Phillips to develop a proprietary gas dehydration technology.
- Announced three contracts totalling \$1 million to supply proprietary technologies for BP, Conoco Phillips and Maersk.
- Sales backlog stands at \$15.1 million at July 1, 2009.

1.2. Material Events and Important Subsequent Events

In this section, all material events and commitments for the three-month period are presented, followed by information on important subsequent events, up to the date of this MD&A.

- On July 16, 2009 ProSep announced the conclusion of the previously announced transaction to convert \$7,845,620 principal amount of indebtedness into Common Shares of the Company and, on July 14, 2009, announced the filing of a final prospectus with securities regulators to raise a maximum of \$10,000,000 by way of rights issue to shareholders. A group of debenture holders, shareholders, directors and executive officers have agreed to commit a minimum investment of \$4,840,000 to the Rights Issue. In view of ProSep's serious financial situation on June 17, 2009, the TSX granted the Company an exemption from a formal valuation and minority shareholder approval under the "financial hardship exemption", see section 8 for details.
- On July 8, 2009 ProSep announced it was awarded three contracts totalling approximately \$1 million (CAD) to supply its proprietary mixing technologies for installation at BP Norge, Conoco Phillips and Maersk Olie og Gas operations.

- On June 17, 2009, ProSep announced its intention to file a preliminary short form prospectus for a Rights Offering to the Shareholders to raise a maximum of \$10,000,000 with a minimum commitment of \$4,840,000 from a group of debenture holders. ProSep also announced an agreement with holders of its existing debentures to convert \$7,845,620 of indebtedness into common shares of ProSep by amending the terms of the Company's existing Debentures and to participate in the Rights Offering as previously described. The Company applied to the TSX for an exemption from a formal valuation and minority shareholder approval under the financial hardship exemption in accordance to Multilateral Instrument 61-101 – Protection of Minority Shareholders in Special Transactions. In response to this request, the TSX advised the Company that reliance on this exemption will automatically result in a TSX de-listing review, see section 8 for details.
- On May 28, 2009 ProSep announced it was awarded under a Joint Industry Project (JIP) agreement with Total, StatoilHydro and ConocoPhillips, a \$1.4 million (CAD) contract for the final stage of development of the ProDry, a proprietary and innovative gas dehydration technology.

2. COMPANY OVERVIEW

2.1. Business Overview

ProSep designs, develops, manufactures, and commercializes process solutions to treat and purify oil, gas, and water for the O&G upstream industry. ProSep has a wide range of conventional and proprietary process equipment sold in units or in packages to O&G producers and engineering procurement and construction firms (“EPC”) with or without process warranties.

Global Business Model: ProSep is a solutions provider supplying traditional and proprietary process equipment packages with process warranty.

ProSep provides: -In-house engineering from process to details; and
-Direct and hands-on involvement with project management to include fabrication, assembly commissioning and services.

ProSep operates around the world in the most important O&G service hubs with operations in Houston (USA), Bergen (Norway), Fusa (Norway), Kuala Lumpur (Malaysia), and Manama (Bahrain). The head office is in Montreal (Canada).

ProSep has approximately 100 employees, mainly technical sales people, process engineers, product engineers and project managers and workers in the Houston assembly shop.

2.2. Corporate Model and Sales Network

ProSep has three diversified business units that promote all proprietary and conventional products across all regional markets. Each unit is a center of excellence based on the expertise and reputation it has built over the years and has its own engineering and sales teams and access to a wide network of agents.



2.3. Business Environment

Lower oil prices and overall weakening in the global economic outlook has affected the level of investments in the O&G industry. In a report published in March 2009 the International Energy Agency said that global upstream oil and gas investment budgets for 2009 have already been cut by around 21% compared with 2008¹. Many projects have been deferred indefinitely or cancelled, with the bulk of postponed projects coming from the Canadian oil sands and non-OPEC countries and smaller O&G producers. For some equipment providers and other suppliers to the upstream O&G industry, this has resulted in a decrease in revenues and lower gross margins as competition has become more aggressive.

However, ProSep believes that reductions in CAPEX spending are not sustainable as overall production rates continue to naturally decline at a rate of 9% per annum² as wells mature and new discoveries become more difficult to recover. Even as demand for oil has shrunk by almost 2%³ in 2008 and 2009, the oil and gas industry will still need to continue investing to replenish production levels and bring new production onstream to prevent a supply crunch. In the longer term, continued reductions in CAPEX are not sustainable and will continue to be a key driver for the upstream oil and gas industry.

During the first half of 2009, the price of oil rallied past US \$70, even as demand continued to slump and inventory levels remained high. This has renewed some interest in exploration and production activities. Since CAPEX investments are determined based on the economic viability of projects, sustained higher levels in the price of oil could be an encouraging sign. Barclays Capital conducted an assessment of the state of investments in the industry and reported that over half of the 402 companies surveyed expected to increase their capital budgets in 2010. The report published in mid-June 2009 forecasts growth in E&P expenditures to return in 2010, with 32 percent predicting an increase of 20 percent or more⁴.

Until the global upstream O&G investments recover across all regions, ProSep's strategy is twofold: leveraging its presence in active markets where investments have not been reduced or an uptake in the level of O&G E&P activities is most probable to occur within the next two quarters, and continuing to control its cost structure which includes an initiative to strengthen its balance sheet. The objective

¹ IEA sees 21% drop in E&P spend, March 25, 2009, Upstream online.

² 2008 IEA WEO

³ The latest Reuters poll of 11 analysts, banks and industry groups shows oil consumption will decline by an average of 1.56 million barrels per day in 2009 to 84.10 million bpd. www.rigzone.com article published April 30, 2009 "Demand drop "steeper than first thought".

⁴ Analysis: Industry Gears Up for Drilling as Crude Rises, June 26, 2009, Rigzone news.

of this strategy is to favorably position ProSep in the context of an anticipated recovery of the industry and improvement of overall economic conditions in 2010.

Reductions in CAPEX have not occurred equally across all regions:

Since National Oil Companies (“NOC”) tend to have longer term expansion plans, are less dependent on capital markets for their financing needs and are slightly less sensitive to short-term oil price variations, their investment projects have not been affected as much as independent O&G producers. For instance, Petrobras⁵, Petronas⁶ and Pemex⁷ have announced substantial increases in their capital expenditure plans. ProSep’s strong presence in these key markets where O&G production costs are lower has and will continue to be an important part of the Company’s offensive strategy. As a result of, ProSep has experienced important growth from its South Asian operations in 2008 and expects this trend to continue into 2009. The Company also believes that its Middle-East operations are very promising.

ProSep continues to actively control its cost structure and has undertaken a successful restructuring and strengthening of its balance sheet. An improved debt to equity ratio and additional liquidities to support growing operations will allow the Company to be well positioned to benefit from a recovery in the upstream O&G market as energy prices stabilize at higher levels and demand for O&G improves as the global economy recovers.

3. PRODUCTS

3.1. Market Segments and Product Penetration

ProSep’s international team of engineers has developed extensive knowledge of process solutions for the upstream O&G treatment market. The Company’s expertise lies in three main production lines: produced water, oil and gas. ProSep designs customer specific solutions using its own products (a mix of proprietary and conventional technologies) and/or other solutions available on the market. A well diversified product offering and custom solutions-oriented service are key to ProSep’s value proposition. The following is a diagram of the Company’s product penetration within each treatment line.

3.2. Product and Services Overview

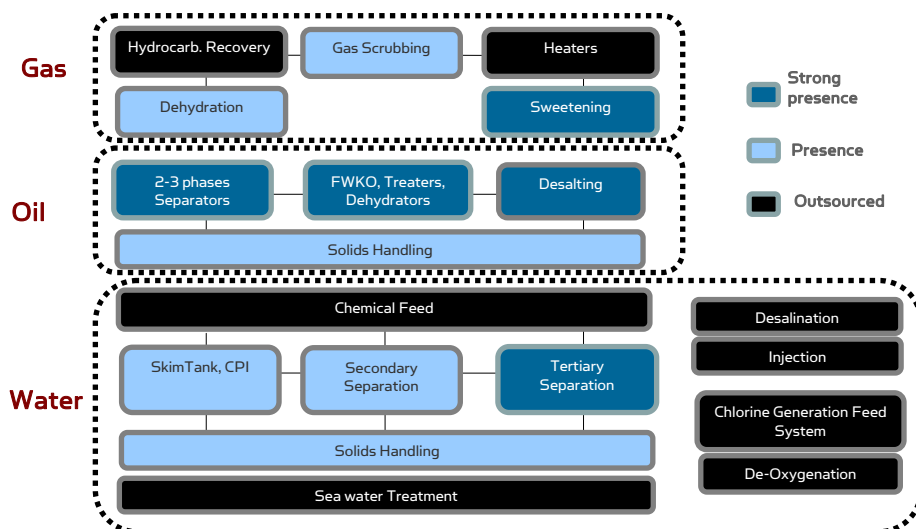
Through its wide range of proprietary and conventional products, ProSep offers custom process solutions to O&G producers that wish to optimize their produced water, oil and gas treatment, separation and polishing activities. The Company has developed practical process solutions that deliver benefits to the environment, enabling O&G producers to meet industry and regulatory requirements while optimizing profitability, an important value-added proposition as production wells mature and volumes of produced water increase globally.

For a complete list and description of the Company’s conventional and proprietary offering, refer to the most recent Annual Management Discussion and Analysis document available at www.sedar.com and www.prosepinc.com.

⁵ In a press release issued January 23, 2009 entitled “Business Plan 2009-2013”, Petrobras projects that 2009-2013 investments will increase by 55% from US\$112 billion for the 2008-2012 period, to US\$174 billion.

⁶ In a news article dated December 2, 2008 from the Malaysian National News Agency on www.bernama.com, Devamany S.Krishnasamy, Deputy Minister in the Prime Minister’s Department is quoted to have said that Petronas’ investments overseas are not affected despite the fall in global oil prices.

⁷ In a news article dated January 23, 2009 by Peter Millard of Dow Jones Newswires, www.rigzone.com, Pemex CEO Jesus Reyes Heróles was reported to have said that the company plans to invest \$20 billion in 2009, up from \$18 billion invested in E&P in 2008.



4. RESULTS OF OPERATIONS

4.1. Contracts

Sales come from several contracts to supply conventional and proprietary gas, oil and water treatment systems to large International Oil and Gas Companies as well as National Oil and Gas Companies. Our systems have been delivered and installed on oilfields around the world.

Table of contracts announced since 2008

Date	Value	Product	Customer	End User
Jan. 2008	US\$0.9 M	Engineering	Worley Parsons	BP Exploration
Apr. 2008	US\$1.4 M	Suction scrubber	Worley Parsons	BP Exploration
Apr. 2008	US\$11 M	Oil separation	Al-Rashed Co.	KOC
Apr. 2008	US\$13 M	Gas separation	Occidental Petro	Occidental Pet.
Jul. 2008	US\$4.8 M	Gas separation	Worley Parsons	BP Exploration
Jul. 2008	\$3.3 M	Glycol regen.	Petronas	Petronas
Sep. 2008	US\$1.1 M	ProSalt Mixer	PEMEX (Mexico)	PEMEX
Sep. 2008	n/a	TORR system	Fores Eng.	ENI and Inagip
Oct. 2008	US\$1.7 M	Gas conditioning	Powertium Eng.	Petronas
Oct. 2008	US\$2.3 M	Gas separation	Skanska LatinoA.	PDVSA
Nov. 2008	US\$1.8 M	Desalter	Hunt Refining	Hunt Refining
Jan. 2009	US\$3.7 M	Fuel gas package	Major EPC firm ¹	Asia Offshore IOC ¹
Feb. 2009	US\$1.2 M	Separator	Worley Parsons	BP Exploration
March 2009	US\$2.0 M	Fuel gas package	Powertium/MMHE	Petronas
March 2009	US\$2.1 M	Gas membrane units	Whiting Petroleum	Whiting Petroleum
May 2009	\$1.4 M	ProDry "JIP"	Total, Statoil, Con.Phil.	n/a
July 2009	\$1 M	ProSalt, ProDry	n/a	BP, Con.Phil, Maersk

¹ Client and end-user couldn't be revealed for competitive reasons.

4.2. Revenues

	US Operations	ProPure & Middle-East	ProSep Asia Pacific	Product Development	Corporate Office	Consolidation & Inter segment eliminations	Consolidated operations
	\$	\$	\$	\$	\$	\$	\$
For the three-month period ended June 30, 2009	5 211 215	1 253 070	2 791 023	233 819	-	(173 156)	9 315 971
For the three-month period ended June 30, 2008	12 994 127	1 748 407	420 967	179 740	-	(202 407)	15 140 834
For the six-month period ended June 30, 2009	15 230 525	2 252 537	5 027 075	407 530	-	(414 916)	22 502 751
For the six-month period ended June 30, 2008	20 761 390	2 889 142	1 240 231	259 932	-	(892 818)	24 257 877

Three-month period ended June 30:

For the three-month period ended June 30, 2009 ProSep reported revenues of \$9,315,971, a 38% decrease from \$15,140,834 for the previous year. This decrease is partly attributable to lower revenues at the Company's US operations, that despite favourable exchange rates which contributed approximately \$0.4 million to revenues, reported second quarter 2009 sales of \$5,211,215 compared to \$12,994,127 for the corresponding period of 2008. Additionally, our Europe & Middle-East operations reported a 28% sales decrease from \$1,748,407 in Q2-08 to \$1,253,070 in Q2-09. Revenue decrease from these business units is a consequence of global reductions in investments in Oil and Gas expenditure programs (please refer to section 2.3 of this MD&A for an update on the current business environment and encouraging signs of recovery in E&P activities). Specifically, many projects that the Company was asked to tender on were delayed or postponed indefinitely and associated with stronger competition. The Company continues to see encouraging results from its Asian business. During the second quarter of 2009, the Asia Pacific operations reported a significant increase in revenues with sales of \$2,791,023; a 560% increase over the corresponding quarter of last year. Growth in ProSep's South-East Asian operations underlines the importance of this region, where FPSO and gas opportunities are still important and where CAPEX spending has remained fairly strong. Since its inception in early 2007, this business unit gained credibility and a reputation in project execution, resulting in invitations to tender on larger projects.

Six-month period ended June 30:

For the six-month period ended June 30, 2009 ProSep reported revenues of \$22,502,751 a 7% decrease from \$24,257,877 in 2008. This decrease is mainly attributable to ProSep's American operations that were affected by the slowdown in US onshore and Gulf of Mexico offshore E&P spending. US Exchange rates positively impacted revenues from this business unit on a year-to-date basis, by contributing approximately \$0.7 million to reported sales of \$15,230,525 compared to \$20,761,390 for the corresponding period of 2008. The Europe & Middle-East operations reported revenue of \$2,252,537 a 22% decrease over \$2,889,142 reported during the six-month period in 2008. Decrease in revenue from these business units relates to timing in contract completion and lower order intake. Asia Pacific operations reported an increase of 300% in sales, from \$1,240,231 to \$5,027,075. Revenues from this entity now represent more than 22% of the Company's consolidated year-to-date revenues compared to a contribution of 5% in 2008. Two important contracts for delivery of fuel gas packages were awarded to ProSep through its regional operations.

4.3. Cost of Goods Sold and Gross Margin

		US Operations	European & Middle-East operations	Asia Pacific operations	Product Development activities	Corporate Office	Consolidation & Inter segment eliminations	Consolidated operations
		\$	\$	\$	\$	\$	\$	\$
For the three-month period ended	Cost of good sold	3 040 813	249 399	2 197 233	285 234	-	(173 156)	5 599 523
June 30, 2009	Gross margin	2 170 402	1 003 671	593 790	(51 415)	-	-	3 716 448
		42%	80%	21%	-22%			40%
For the three-month period ended	Cost of good sold	9 819 221	981 984	236 382	75 728	-	(202 407)	10 910 908
June 30, 2008	Gross margin	3 174 906	766 423	184 585	104 012	-	-	4 229 926
		24%	44%	44%	58%			28%
For the six-month period ended	Cost of good sold	10 785 126	972 936	3 824 782	401 703	-	(414 916)	15 569 631
June 30, 2009	Gross margin	4 445 399	1 279 601	1 202 293	5 827	-	-	6 933 120
		29%	57%	24%	1%			31%
For the six-month period ended	Cost of good sold	15 392 435	1 833 347	1 018 581	143 827	-	(892 818)	17 495 372
June 30, 2008	Gross margin	5 368 955	1 055 795	221 650	116 105	-	-	6 762 505
		26%	37%	18%	45%			28%

Gross margin for the second quarter of 2009 was \$3,716,448 or 40% of revenues compared with \$4,229,926 or 28% of revenues for the comparative 2008 period. Consolidated quarterly margins are unusually high due to savings in commissioning of projects and increased labour component compared to material input of contracts delivered during the period. For the six month period ended June 30, 2009 gross margin represented 31% of revenues or \$6,933,120 compared with 28% or \$6,762,505 a year before. These margin levels for the six-month period ended June 30, 2009 are more indicative of our overall average gross margin target.

Gross margins as a percentage of revenues at the American operations improved for both the second quarter at 42% for Q2-09 compared to 24% for Q2-08 and the six month period at 29% for 2009 compared to 26% for the same period last year. This is mainly due to savings in commissioning of projects.

Gross margins as a percentage of revenues at the Europe & Middle-East operations were 80% for the second quarter of 2009, up from 44% for the corresponding quarter of 2008, and 57% year-to-date, up from 37% for the corresponding period in 2008. These improvements reflect higher labour components compared to material input in the contract mix.

Gross margins as a percentage of revenues at the Asia Pacific operations were 21% for the second quarter of 2009, down from 44% for the corresponding quarter of 2008 and 24% year-to-date, up from 18% for the corresponding period of the previous year. Last year's second quarter gross margins were unusually high because of the important labour components of the contracts delivered during that period. On a year-to-date basis, gross margin improvements reflect the higher level of sales allowing this business unit to capture operational synergies.

4.4. Expenses and EBITDA*

Detailed expenses and EBITDA for the 3 month periods ended June 30, 2009 and 2008

	Three months ended June 30,	
	2009	2008
	\$	\$
Revenue	9,315,971	15,140,834
Sales and marketing	631,672	428,991
Research and development	139,137	213,930
General and administrative	2,472,232	2,210,108
	3,243,041	2,853,029
EBITDA	473,407	1,376,897

Detailed expenses and EBITDA for the 6 month periods ended June 30, 2009 and 2008

	Six months ended June 30,	
	2009	2008
	\$	\$
Revenue	22,502,751	24,257,877
Sales and marketing	1,105,651	990,055
Research and development	300,633	517,135
General and administrative	5,201,079	4,319,479
	6,607,363	5,826,669
EBITDA	325,757	935,836

* EBITDA is a non-GAAP measure and the Company defines it as earnings or loss from operations excluding depreciation and amortization, financial charges and income taxes. Please refer to section called non GAAP measurement

Earnings before interest, taxes, depreciation and amortisation (EBITDA) stood at \$473,407 for the three-month period ended June 30, 2009 compared with \$1,376,897 for the same period in 2008. This \$903,490 decrease is mostly attributable to decrease in revenue and resulting gross margin but also to increased Sales and marketing expenses and General and administrative expenses (see below).

When comparing the six month period ended June 30, 2009 and 2008, the EBITDA stood at \$325,757 in 2009 compared to \$935,836 in 2008. This decrease is mainly related to higher General and administrative expenses (see below).

Sales and Marketing Expenses

Sales and marketing expenses were \$631,672 or 7% of revenue for the three-month period ended June 30, 2009 compared to \$428,991 or 3% for the three-month period ended June 30, 2008. This

increase is mainly related to the US operations that introduced a new conventional produced water line and dedicated more resources to support the increased level of quotations.

For the six month period ended June 30, 2009 sales and marketing expenses were \$1,105,651 (5% of revenue) compared to \$990,055 (4% of revenue) for the previous year. Net increase is the result of the above mentioned additional resources of the US compensated by reductions in the Company's sales and marketing team in Norway and better cost control measures that took place in the second quarter of 2008.

The majority of the sales and marketing expenses relate to salaries, marketing, promotional and travel activities.

Research and Development Expenses

Research and development expenses decreased to \$139,137 in the three-month period ended June 30, 2009 from \$213,930 in the three-month period ended June 30, 2008. For the six month period ended June 30, 2009 such expense was \$300,633 compared to \$517,135 a year before. The expenses incurred by the Company relating to R&D activities (mostly salaries) have and will continue to be reduced as development activities are increasingly conducted in collaboration with industry partners.

ProSep's R&D model:

Development activities are conducted under the umbrella of joint industry partnerships (JIP) with super major oil and gas companies. This is a highly efficient collaboration model that allows the Company to develop pioneering technologies by addressing a fair portion of project financing needs and validate market interest before the applications reach commercialization. The Company retains all property rights including technology, patents and licensing fees relating to future sales of all products developed.

General and Administrative Expenses

General and administrative ("G&A") expenses were \$2,472,232 for the three-month period ended June 30, 2009 compared to \$2,210,108 for the three-month period ended June 30, 2008. The increase in quarterly G&A expenses of approximately \$0.3 million is explained by a higher US exchange rate which accounts for about \$0.1 million and by the new Bahrain office opened in late 2008. Also, reduced level of activity in the European & Middle-East operations added pressure on the G&A expense due to lower staff cost allocation to contracts. Finally the hiring of a General Manager as well as an Administrative Manager in this unit contributed to the increase.

For the six month period ended June 30, 2009 G&A expenses were \$5,201,079 compared to \$4,319,479 for the corresponding period of 2008. The higher US conversion rate explains about \$250,000 of the increase. The new Bahrain office accounts for about \$0.3 million of the increase. Here also, reduced level of activity in the Europe & Middle-East unit added pressure on the G&A expense due to lower staff cost allocation to contracts as well as the hiring of a General Manager and an Administrative Manager contributed to the increase. Finally, a portion of the increase is explained by additional employees at our Asia Pacific unit in line with increased level of activities.

4.5. Goodwill Impairment

Goodwill represents the excess of the purchase price of an acquired business over the fair value of the identifiable assets acquired and liabilities assumed. Management tests for impairment of goodwill on an annual basis and at any other time if events occur or circumstances change that would indicate that it is more likely than not that the fair value of a reporting unit has been reduced below its carrying amount.

Factors considered important which could trigger an impairment review include, but are not limited to, significant underperformance relative to expected historical or projected future operating results, significant changes in the manner of use of the acquired assets or the strategy for the overall business, a downturn in the Canadian and international economies, significant negative industry or economic trends, a significant decline in the stock price for a sustained period and the Company's market capitalization relative to net book value.

The goodwill impairment test is a two-step process. Step one consists of a comparison of the fair value of a reporting unit with its carrying amount, including the goodwill allocated to the reporting unit. Measurement of the fair value of a reporting unit may be based on one or more fair value measures including present value techniques of estimated future cash flows and estimated amounts at which the unit as a whole could be bought or sold in a current transaction between willing parties. If the carrying amount of a reporting unit exceeds the fair value, step two requires the fair value of the reporting unit to be allocated to the underlying assets and liabilities of that reporting unit, resulting in an implied fair value of goodwill. Should the carrying amount of the goodwill of the reporting unit exceeds the implied fair value of that goodwill, an impairment loss equal to the excess will be recorded in net earnings (loss).

In light of the Company's current market capitalization and the recently announced balance sheet restructuring initiative, for which details can be found in the section 8 of this MD&A, the Company has performed an interim testing of the goodwill valuation. Such test considered the estimated impact of the balance sheet restructuring initiative, comprised of \$7,845,620 principal amount of indebtedness conversion into shares and committed amount under the share rights offering of \$4,840,000, and has estimated the anticipated fair value of the Company using a price of \$0.13 per share which represents the conversion price of the debenture (announced in June 2009 and closed on July 16, 2009).

Based on those preliminary estimates, the Company determined that the anticipated value of Prosep is below its expected carrying value and that impairment loss of goodwill was probable. Accordingly, an impairment charge of \$6.5 million was estimated and recorded in the quarter. This charge was allocated to the business units using their respective estimated value. Management has not yet performed step two due to time constraints, but will proceed in the future. This could result in potential further write down of goodwill.

4.6. Decrease in fair value of ABCP

No impairment charge related to the investment in asset backed commercial paper was taken in the three and six month periods ended June 30, 2009. Six month period ended June 30 2008, includes an impairment charge of \$450,000 which was recorded in the first quarter of 2008. Please refer to note 9 of the June 30, 2009 consolidated financial statements for more details.

4.7. Financial charges

Total financial charges were \$692,745 for the three-month period ended June 30, 2009 compared with \$566,352 for the corresponding 2008 period. This increase stems from a \$203,977 gain on a derivative instrument held in 2008 and the difference in foreign exchange loss that went from \$140,688 in 2008 to \$31,262 in 2009. The foreign exchange loss is mainly the consequence of the US and Norwegian division's balance sheet conversion.

For the six-month period ended June 30, 2009 the total financial charges stood at \$2,031,233 compared with \$2,525,222 for the corresponding 2008 period. The variation is explained by higher interest on long term debt due to higher debt level. This increase is more than compensated by a lower 2009 foreign exchange loss that went from \$1,354,568 to \$572,888.

4.8. Income Tax

Income taxes were \$33,807 in the three-month period ended June 30, 2009 compared with \$595,383 for the corresponding period of 2008. For the six-month period ended June 30, 2009 the income taxes were \$156,713 compared with \$719,409 for the same 2008 period. The Company's operating revenues and expenses are reported by various business units located around the world and subject to various fiscal jurisdictions. Some of these business units are profitable while others have yet to generate net income and some have accumulated tax losses. ProSep's management is working on optimizing its tax structure.

4.9. Net Loss

The Company reported a net loss of \$7,147,852 or \$0.11 per share for the three-month period ended June 30, 2009 compared with a net loss of \$162,122 for the three-month period ended June 30, 2008. The increase in the net quarterly loss is largely attributable to the \$6,500,000 impairment of goodwill but also to reduced sales level and increases in both sales & marketing and G&A expenses.

For the six month period ended June 30, 2009 net loss was \$9,132,368 or \$0.14 per share compared to \$3,499,936 or \$0.06 per share for the corresponding period in 2008. The increase in the net loss of about \$6 million is mostly attributable to the \$6,500,000 write-down of goodwill compensated by a 2008 decrease in fair value in asset backed commercial paper of \$450,000.

Basic and diluted loss per share was calculated using the weighted-average number of Common Shares outstanding during the period giving 64,443,451 shares (62,556,566 in 2008).

4.10. Other Items

4.10.1. Legal proceedings

ProSep has a policy to vigorously defend its intellectual property. In October 2005, the Company initiated legal proceedings before the Québec Superior Court against a former employee and related parties seeking injunctive relief for misappropriation and illegal use of proprietary information belonging to the Company. It is not expected that further developments will occur until trial which has been set to begin on November 9, 2009.

ProSep is the defendant in a claim made by Westend Enviro Consultants ("Westend"). Westend commenced an action in the Supreme Court of British Columbia on March 31, 2006 claiming damages for breach of contract and fraudulent misrepresentation. Westend claims that ProSep entered into an agreement with it to provide equipment and a chemical for remediation work on a site in B.C. Westend alleges that it paid a total of \$280,000 to ProSep and that it did not receive the specified chemical, thereby making the machine worthless. The amount of the claim as stated in the pleading is \$280,000. ProSep filed a Statement of Defence on June 9, 2006, denying any liability. Document discovery has largely been completed. Examinations for discovery have been conducted. Further information and document requests have been answered. No trial date has been scheduled. It is premature to assess the likelihood of successfully defending this claim. No amount has been accrued.

5. SUMMARY OF QUARTERLY RESULTS

5.1. Selected quarterly financial performance

	Year Ending December 31, 2009		Year Ending December 31, 2008				Six-Month Period Ending December 31, 2007		Year Ending June 30, 2007	
	Q2	Q1	Q4	Q3	Q2	Q1	Q2	Q1	Q4	Q3
Revenue	9,316	13,187	14,798	12,548	15,141	9,117	5,683	102	9,402	16,415
Net income (loss)	(\$7,148)	(\$1,985)	27 ¹	1,848 ²	(162)	(3,338)	(5,012)	(3,063)	(2,928) ³	(1,864) ⁴
Basic EPS* (loss)	(0.11)	(0.03)	0.00	0.03	(0.00)	(0.05)	(0.09)	(0.07)	(0.06)	(0.04)
Diluted EPS (loss)	n/a	n/a	0.00	0.03	n/a	n/a	n/a	n/a	n/a	n/a

*EPS: Earnings per share

Revenue and income are in thousands, all amounts are in CAD \$.

¹Net income includes a reversal of \$1,280,921 of warranty provision and \$1,645,356 gain on foreign exchange

²Net income includes a reversal of \$1,280,920 of warranty provision and \$1,886,988 gain on foreign exchange

³Net loss includes a \$1,385,008 warranty provision

⁴Net loss includes a \$1,176,833 warranty provision

6. BALANCE SHEET ITEMS

6.1. Assets

Total assets as at June 30, 2009 were \$53,626,048 a decrease of \$15,869,562 from the December 31, 2008 amount of \$69,495,610. At the end of June 2009, ProSep had \$5,435,714 in cash and cash equivalents compared with \$7,615,119 as at December 31, 2008. As at December 31, 2008, ProSep had \$1,037,846 of short term restricted cash related to the acquisition of Pure Group AS. During the second quarter of 2009 most of this amount was released to the seller. The Company's receivables were \$17,359,200 as at June 30, 2009 compared to the December 31, 2008 amount of \$20,004,848. This decrease is in line with the year to date revenue reduction. Prepaid expenses were \$1,146,114, an increase over the amount of \$886,085 as at December 31, 2008. This increase is mostly related to an amount of \$327,966 that was recorded as deferred costs in relation with the balance sheet restructuring. (Refer to section 8,4 for more details). As at December 31, 2008, ProSep had \$3,158,986 (18,000,000 NOK) of long term restricted cash required under the credit facility with DNB Nor. On April 29 2009, the Company agreed to a new covenant structure on this credit facility which enabled the release of this amount.

Total long term investment stood at \$5,438,663 as of June 30, 2009. The decrease from \$5,815,000 as at December 31, 2008 is related to interest received.

Goodwill totalled \$13,907,126 as at June 30, 2009 a decrease of \$6,500,000 from December 31, 2008. Such decrease is related to a write-down done in the second quarter of 2009. (Refer to section 4.5 for more details).

6.2. Liabilities

Total liabilities at June 30, 2009 were \$43,064,800 representing a decrease of \$6,899,908 from the December 31, 2008 amount of \$49,964,708. The variance is mainly a result of a decreased use of the DnBNor bank credit facility from \$4,396,044 at December 31, 2008 to \$2,920,167 on June 30, 2009. Accounts payable and accrued liabilities account for \$6,382,194 of the decrease and is related to advancement and /or completion of major contracts.

Deferred revenues totalled \$1,964,997 as of June 30, 2009 representing a \$1,480,919 increase over the December 31, 2008 figure.

In April 2009, the company accepted the offer from National Bank of Canada whereby the ABCP related term loan maturing in April 2009 was replaced by two long term revolving credit facilities totalling \$7,180,564.

For more information on the Company's debt structure, refer to notes 10 and 11 of the financial statements.

6.3. Equity

The Company's net equity as at June 30, 2009, was \$10,561,248, compared to \$19,530,902 as at December 31, 2008 resulting from the net loss for the six-month period ended June 30, 2009.

As of June 30, 2009 ProSep had 64,443,451 common shares issued and outstanding, compared to 62,556,566 on December 31, 2008.

7. OFF BALANCE SHEET ARRANGEMENTS

During the year ended December 31, 2008 ProSep entered into a commitment lease agreement for a new 55,000 square foot manufacturing and assembly facility located in Houston, Texas. The Company has moved its manufacturing and assembly capacity to this new premise during the second quarter of 2009. This expansion will enable the Company to double the size of its Houston operation and allow for a significant increase in its production capacity as well as diversify its product offering.

8. LIQUIDITY AND CAPITAL RESOURCES

8.1. Cash Flows

Operating Activities

During the three-month period ended June 30, 2009, ProSep generated a negative cash flow from operations of \$3,707,142 and a negative cash flow before changes in non-cash working capital items of \$418,748. During the three-month period ended June 30, 2008, the Company generated cash flow from operations of \$1,370,967 and a cash flow before changes in non-cash working capital of \$87,671. During the six-month period ended June 30, 2009, ProSep generated a negative cash flow from operations of \$3,960,362 and a negative cash flow before changes in non-cash working capital items of \$1,000,087. During the six-month period ended June 30, 2008, the Company generated

negative cash flow from operations of \$1,536,741 and a negative cash flow before changes in non-cash working capital of \$585,772.

Operating cash flows for both the quarter and the six month period ended June 30, 2009 decreased from the corresponding 2008 respective periods due to increased investment in working capital. Lower operational and financial results explain reduction in operating cash flow before working capital. (See section 4 for more details).

Investing Activities

Investments during both the quarter and the six-month period ended June 30, 2009 were mostly made in property & equipment for the new 55,000 square foot assembly facility in Houston.

Financing Activities

Differences in financing activities for both the quarter and the six-month period ended June 30, 2009 compared to the respective period of 2008 are mostly related to the release of the restricted cash (see section 6.1) as variation in the short term credit facility.

8.2. Liquidity, working capital and credit facility

As at June 30, 2009, ProSep had \$5,435,714 of cash and cash equivalents. On December 31, 2008, the Company had \$7,615,119 of cash and cash equivalents, \$1,037,846 of short term restricted cash and \$3,158,986 of long term restricted cash. See note 7 of the June 30, 2009 financial statements for more details on the restricted cash.

As at June 30, 2009 ProSep had net unrestricted working capital of \$1.7 million (non GAAP measure defined for the purpose of this section as current assets, excluding restricted cash, less current liabilities excluding accrual related to restricted cash), compared to a negative \$6.3 million as at December 31, 2008. Such improvement in the unrestricted working capital level is mainly related to the release of the above mentioned \$3,158,986 restricted cash combined with the \$7.2M National Bank short term loan that was converted into a long term loan.

Principal use of working capital is to provide for the financing of various contracts. The level of working capital can be quite volatile during a given period, depending on contracts advancement. A portion of the working capital is financed through customer advances or progress payments on contracts. In some cases, such advances or payments require the issuance of letters of guarantee (LG) using the DnB Nor 15 million NOK facility (\$2,707,483 at June 30, 2009) or support provided by Export Development Canada ("EDC"). As at June 30, 2009 the total (DNB & EDC) outstanding LG were \$4,056,735 (\$4,002,231 as at December 31, 2008).

National Bank loan: As of December 31, 2008, credit facilities included \$7.2 million of short term loan with National Bank which was converted in April 2009 into two long term revolving credit facilities.(please refer to note 11 of the financial statements as of June 30, 2009 for more details).

DNB Nor release of restricted cash: At December 31, 2008, the Company was in breach of one of its financial covenants under the credit facility with DnB NOR. The breached covenant called for ProSep to repay entirely the line of credit twice a year. Due to the increase in backlog, ProSep required full usage of its working capital resources and was thus unable to comply with this covenant in due time. A long term waiver was obtained for such covenant breach. In exchange for the waiver, the Company agreed to maintain an amount of 18,000,000 NOK in a separate escrowed bank account to be held until determination of a new covenant structure. In April 2009, DnB Nor Bank ASA agreed to a new covenant structure outlining its 45,000,000 NOK loan facility (31,500,000 NOK at June 30, 2009)

so as to release the 18,000,000 NOK (approximately \$3,4 million as of April 30, 2009) previously escrowed pending the renegotiation relating to the new covenant structure.

ProSep's current bank credit facilities:

Credit facilities as of June 30, 2009

Lender	Description	Currency	Amount (CAD)	Drawn (CAD)	Available (CAD)
DNB Nor	Overdraft	NOK/USD	\$5,324,718	\$2,920,167	\$2,404,551
	F/X forward facility	NOK	\$90,249	\$0	\$90,249
	Guarantee facility	NOK	\$2,707,483	\$2,270,973	\$436,510

ProSep's debt and credit facilities repayment schedule as of June 30, 2009

	Carrying Amount	One – six months	Six - twelve months	One – five years	More than five years
Bank credit facilities	\$2,920,167	-	\$2,920,167	-	-
Long Term debt	\$22,127,103	\$2,524,915	\$1,324,427	\$18,277,761	-
Total	\$25,047,270	\$2,524,915	\$4,244,594	\$18,277,761	-

ProSep Inc. is a parent holding company with no real operating assets or sources of income other than shares of subsidiaries, operating companies and ownership of the TORR technology. ProSep Inc.'s cash flow and, consequently, its ability to meet its debt service obligations is highly dependent upon the receipt of funds from its subsidiaries in the form of loans, dividends, advances or otherwise. As mentioned above, in April 2009, the Company entered into an amended covenant structure in relation to the DnB loan facility. Under this amended debt agreement, ProSep is subject to certain financial and negative covenants, including restrictions on its ability to incur indebtedness, pay dividends, make certain other payments, create liens, sell assets and engage in mergers. The operating subsidiaries of the Company are also restricted from transferring funds in the form of dividends, loans or otherwise to the Company in excess of \$3.7 million for fiscal year 2009. Therefore, considering the Company's debt obligations, debt repayment schedules and negative cash flow from operating activities, ProSep initiated a balance sheet restructuring program to recapitalize the Company, negotiate repayment schedules and reduce overall debt.

8.3. Balance sheet restructuring:

In order to restructure its balance sheet and remedy the above mentioned difficult financial situation, the Company announced on June 17, 2009 its intention to convert a significant portion of its outstanding debentures into equity and initiated a Rights Offering to its shareholders to raise a maximum of \$10 million (including a firm commitment of \$4.8 million from a group of debenture holders). This restructuring and reduced overall debt will preserve cash for operations.

This initiative consisted of:

- Filing of a short form prospectus for a Rights Offering to Shareholders as of July 24, 2009 ("the Record Date") to raise a maximum of \$10,000,000 with a firm commitment of \$4.9 million from a group of debenture holders, shareholders, directors and executives of the Company; and
- An agreement with the holders of its existing debentures to convert \$7,845,620 of principal amount of indebtedness into common shares of ProSep by amending the terms of the Company's existing Debentures and to participate in the Rights Offering, as mentioned in the previous bullet, so as to ensure that ProSep realizes gross proceeds of at least \$4,840,000.

Overall, this initiative reduces the principal amount of indebtedness by \$7,845,620, short term debt repayment obligations by over \$2,444,000 and will provide additional liquidities for general working capital purposes.

The following table details the proforma balance sheet impact of the restructuring as of June 30, 2009:

In thousands of CAD	As at June 30, 2009	After giving effect to the debt conversions and to the minimum commitment of the Rights Offering. ⁽¹⁾	Further adjusted to give effect to the full exercise of the rights offering. ⁽²⁾
ASSETS			
Current assets			
Cash and cash equivalents	5,436	9,268	14,428
Other assets	19,565	19,565	19,565
	<u>25,000</u>	<u>28,832</u>	<u>33,992</u>
Long term assets			
	28,626	28,626	28,626
	<u>53,626</u>	<u>57,458</u>	<u>62,618</u>
LIABILITIES			
Current liabilities			
Bank Credit Facilities	2,920	2,920	2,920
A/P and accrued liabilities	14,571	13,796	13,796
Other current liabilities	1,965	1,965	1,965
Current portion of long term debt	3,849	1,679	1,679
	<u>23,306</u>	<u>20,361</u>	<u>20,361</u>
Long term liabilities			
Long term debt	18,278	14,984	14,984
Other liabilities	1,481	1,481	1,481
	<u>43,065</u>	<u>36,826</u>	<u>36,826</u>
Shareholders' Equity			
Share capital	55,489	71,055	76,215
Contributed Surplus	12,690	11,305	11,305
Deficit	(57,617)	(61,728) ⁽³⁾	(61,728)
	<u>10,561</u>	<u>20,632</u>	<u>25,792</u>
Total liabilities and equity	<u>53,626</u>	<u>57,458</u>	<u>62,618</u>
Common shares outstanding	64,443	162,025	201,717

(1) Adjusted to give effect to the exchange of the existing debentures and a portion of the related interest payable pursuant to the debt conversions, net of allocated estimated transaction costs of \$546,000. Also adjusted to give effect to the minimum commitment of the rights offering of \$4,840,000 net of allocated estimated transaction costs of \$354,000.

(2) Adjusted to give effect to the receipt of additional proceeds assuming the full exercise of all the rights pursuant to the Rights Offering.

(3) Includes the estimated aggregate net loss of \$2,076,000 arising from the accounting for the settlements of debts pursuant to the debt conversions and a net foreign exchange gain of \$108,000 arising from the remeasurement of US dollar denominated debenture from a rate of 1.1625 at June 30, 2009 to a rate of 1.1355 used to determine the number of common shares issued pursuant to its conversion.

The improved balance sheet resulting from the transaction will enable ProSep to finance its future capital requirements from cash on hand and cash flow from operating activities.

In addition, it should be noted that ProSep's ability to generate operating income is reliant on the underlying health of the O&G industry. The global economic environment affects demand for oil and gas, thus affecting the price of these commodities and, in turn, the industry's willingness to invest in exploration and development CAPEX, including in the types of process equipment and services provided by the Company and its subsidiaries. Any substantial reduction in demand for oil and gas as a result of a global recession, accompanied by lower prices and reductions in CAPEX programs, could therefore negatively impact ProSep's business.

Since the Company's incorporation, operating results have fluctuated and there can be no assurance that ProSep will operate profitably in the future. Considering general economic conditions, operating results may vary from quarter to quarter, depending on a number of factors, including:

- the introduction and market acceptance of new products and new variations of existing products;
- the activities of competitors;
- ability to control expenses;
- variations in the timing of orders and subsequent shipments;
- the length of customers' approval processes or market tests;
- changes in product mix;
- lack of liquidity;
- changes in capital spending;
- unforeseeable or unavoidable delays in large-scale customer projects;
- higher interest rates;
- Changes in currency rates.

Because quarterly revenues could be dependent upon a relatively small number of large transactions, even minor variations in the rate and timing of conversion of sales prospects into revenue could cause the Company to plan or budget inaccurately, and such variations could adversely affect our financial results. Delays, reductions in amounts or cancellations of customers' purchases could adversely affect the business, financial condition and results of operations. In light of the foregoing, quarter-to-quarter comparisons of operating results are not necessarily meaningful and should not be relied upon as indications of likely future performance or annual operating results.

Details of the debenture amendments and conversions:

The Company had the following creditors outstanding before the July 16, 2009 amendments and conversions:

- i) \$1,500,000 principal amount 12% Secured Convertible Debentures due October 29, 2009
- ii) US\$4,000,000 principal amount 13.25% Unsecured Debentures with a final maturity date of April 1, 2013; and
- iii) \$5,090,000 principal amount 13% Unsecured Convertible Debentures due April 23, 2013.

Holders of these debentures agreed to amend the terms of these Debentures and to partially convert (representing an amount of \$7,178,500), at an amended conversion price of \$0.13, such Debentures and \$667,120 of accrued interest into an aggregate of 60,350,923 Common Shares.

Shares received from these conversions settled before the Record Date for the Rights Offering of July 24, 2009. Certain holders of Debentures have further agreed to exercise the Rights attached to all the Common Shares they hold as of the Record Date pursuant to their Basic Subscription Privileges and, if required, Additional Subscription Privileges to the fullest extent permitted by securities laws, ensuring that ProSep realizes gross proceeds from the Rights Offering of at least \$4,840,000.

Amendments and conversions to the debentures were as follows:

- (i) \$1,500,000 principal amount 12% Secured Convertible Debentures were entirely converted into Common Shares at the amended conversion price of \$0.13;

- (ii) the US\$4,000,000 principal amount 13.25% Unsecured Debentures was exchanged entirely for a 13% Unsecured Convertible Debentures of equivalent principal amount with a final maturity date of April 23, 2013; and
- (iii) \$5,678,500 principal amount of the 13% Unsecured Convertible Debentures was converted into Common Shares at the amended conversion price of \$0.13 (reduced from \$0.45).

As a result, the remaining Debentures outstanding have a principal amount of \$3,953,500. The Debentures bear interest at an annual rate of 13.25% (increased from 13%) and the maturity date was extended from April 2013 to July 2014. The amended Debentures are convertible, at the option of the holders, into Common Shares based on a conversion price of \$0.30 and redeemable in whole or in part by the Company at any time after the second anniversary of the Amendments. Interest are payable every six months in cash.

The closing of the Amendments, which was subject to regulatory approval (including approval by the Toronto Stock Exchange) (the "TSX") and to other customary closing conditions, occurred on July 16, 2009. As a result of the Amendments, the Company issued 60,350,923 Common Shares representing a dilution of 94% of all the issued and outstanding Common Shares at the date of the conversion and now has a total of 124,794,374 Common Shares issued and outstanding.

Financial hardship exemption and TSX delisting review:

The Amendments were unanimously approved by all directors of the Company who are free from any interest and unrelated to the parties involved in the proposed transaction. Some of these Amendments constituted a related party transaction in accordance to *Multilateral Instrument 61-101 – Protection of Minority Shareholders in Special Transactions* ("MI 61-101"). The Company relied on the financial hardship exemption included in Sections 5.5(g) and 5.7(e) of MI 61-101 to be exempted from the requirement for a formal valuation and a minority shareholder approval. In addition, the Company applied to the TSX for an exemption, in accordance with Section 604(e) of the TSX Company Manual, from the requirement to obtain shareholder approval for the Amendments in consideration of the serious financial circumstances of the Company, as described in the Management's Discussion and Analysis for the period ended March 31, 2009. The TSX requires shareholder approval when the number of Common Shares to be issued under such transactions exceeds a 25% dilution. In this context, the terms of the Debentures were amended mainly to provide for a reduced conversion price for the Debentures that was lower than the market price, less the permissible discount under TSX rules, and the fact that the transaction could materially affect the control of the Company because of the increased share ownership of FondAction.

ProSep's reliance on this exemption automatically results in a TSX de-listing review. This process is intended to insure that ProSep continues to meet TSX listing requirements. The Company's reliance on the financial hardship exemption provisions under MI 61-101 and the TSX Company Manual is based on determinations by the board of directors of ProSep and all of its independent directors, acting in good faith, that the Company was in serious financial difficulty, that the transaction was designed to improve its financial position and that the terms of the transaction are reasonable under such circumstances.

The Company was granted 210 days in which to regain compliance with the TSX listing requirements, pursuant to the Remedial Review Process. ProSep intends to comply with all the continued listing requirements as set forth in Part VII of the TSX Company Manual available on the TSX website and believes it will be able to address this with the TSX before the deadline.

Details of the Rights Offering:

On July 14, 2009, ProSep filed a final short form prospectus to raise a maximum of \$10,000,000 in gross proceeds by issuing to shareholders (that are residents of Canada and eligible shareholders in other jurisdictions of record on July 24, 2009, one right for each common share of ProSep held. The Rights entitle Eligible Holders to subscribe for and purchase from the Company an aggregate of approximately 76,923,077 Common Shares (assuming full subscription). 1.6223 Rights entitle the

holder to subscribe for one Common Share at the subscription price of \$0.13 on or before 4:00 p.m. (local time at place of exercise in Canada) on August 20, 2009, the expiration date. Assuming full subscription, the approximate net proceeds are estimated to be \$9,694,000 and will be used for (i) funding lines of credit necessary to ensure proper investment in working capital; (ii) for issuing performance bonds to customers; and (iii) a small portion (less than \$500,000) will be used for capital expenditures mainly in small equipment for the Houston plant and some demonstration pilot units of our proprietary products within the next two years. Moreover, the lower debt to equity ratio and the cash available will enable ProSep to have greater access to Export Development Canada guarantee programs and negotiate better lines of credit and lines for issuing guarantees with the Company's bank.

As mentioned in the previous section discussing the debenture conversions, a group of debenture holders has agreed to participate in the rights offering for gross proceeds of at least \$4,840,000.

Following the closing of the Amendments that occurred on July 16, 2009 and the rights offering (assuming full subscription) that is expected to close on August 20, 2009, ProSep will have 201,717,451 Common Shares issued and outstanding.

9. TRANSACTIONS WITH RELATED PARTIES

During the quarter ended June 30, 2009 ProSep did not make any transactions with related parties.

10. DESCRIPTION OF CAPITAL STRUCTURE

Our authorized share capital consists of an unlimited number of common shares, of which 64,443,451 common shares issued and outstanding, on June 30, 2009. We are authorized to issue an unlimited number of common shares without par value. The holders of the common shares are entitled to receive notice of and to attend all annual and special meetings of shareholders and to one vote in respect of each common share held at all such meetings. The holders of the common shares are entitled, at the discretion of our board of directors, to receive any or all of our profits or surplus properly available for the payment of dividends, as well as any dividend declared by the Board of Directors and payable by the Company on the common shares. The holders of the common shares will participate ratably in any distribution of our assets upon liquidation, dissolution or winding-up or other distribution of our assets among our shareholders for the purpose of winding up our affairs. Such participation will be subject to the rights, privileges, restrictions and conditions attached to any securities issued and outstanding at such time ranking in priority to the common shares upon liquidation, dissolution or winding-up.

As at June 30, 2009, options to purchase 420,000 common shares of the Company issued pursuant to our Stock Option Plan were outstanding.

The Company grants restricted share units to attract, retain and motivate key personnel and reward officers and employees for significant performance and distributable cash flow growth. Each restricted share unit is equal in value to one common share of the Company. The shares will be issued from the treasury of the Company. The number of shares reserved at any time must not exceed 10% of the aggregate number of shares.

As at June 30, 2009, 3,986,778 restricted share units were issued and outstanding.

As at June 30, 2009, warrants to purchase 27,635,027 common shares of the Company were outstanding. Pursuant to the terms of the subscription agreement dated April 24, 2008, ProSep issued 2,036,000 common share purchase warrants at an exercise price of \$0.30 per share. As part of the private placement concluded on the same date, ProSep agreed to reduce the exercise price of the 2,424,242 warrants issued in October 2007 to Fondation, at an exercise price from \$1.65 to \$0.55 per common share. The maturity date of the warrants has not been amended. Pursuant to the terms of the subscription agreement dated October 29, 2007, we issued warrants to purchase 2,424,242 common shares at an exercise price of \$1.65 per common share for a period of five years to Fondation. Pursuant to the terms of subscription agreements dated June 23, 2005, we issued 17,000,000 units of the Company at a purchase price of \$0.50 per unit for gross proceeds of \$8,500,000, with each unit consisting of one common share of the Company and one warrant and with each warrant being exercisable for one common share of the Company at a price of \$0.65 per common share until November 2, 2009. The broker warrants were also issued as part of this transaction of which all have been exercised. Pursuant to the terms of subscription agreements dated November 2, 2004, we issued warrants to purchase 4,615,385 common shares of the Company at an exercise price of \$0.65 per common share until November 2, 2009 to the FTQ, Innovatech, FIDD and BDC.

11. CRITICAL ACCOUNTING ESTIMATES

Please refer to June 30 2009 consolidated financial statements as well as annual 2008 Management and discussion analysis (MD&A).

12. FINANCIAL DISCLOSURE

In order to comply with the Canadian Securities Administrator's Multilateral Instrument 52-109 ("MI 52-109"), the Company has conducted an evaluation of its disclosure controls and procedures and internal controls during the year ended December 31st, 2008. The implementation of MI 52-109 involves a continuous improvement process, which has brought the Company to ensure that all relevant processes and controls were documented. Refer to the previous interim and 2008 annual MD&A.

12.1. Disclosure controls and procedures

Our disclosure controls and procedures are designed to provide reasonable assurance that material information required to be disclosed is recorded, processed, summarized and reported within the time periods specified under Canadian securities laws, and include controls and procedures that are designed to ensure that information is accumulated and communicated to the management committee members, including the President & CEO and the CFO, to allow timely decisions regarding required disclosure.

As of December 31, 2008, an evaluation was carried out, under the supervision of and with the participation of management, including the President & CEO, the CFO, and the Treasury Director, of the effectiveness of the disclosure controls and procedures as defined under MI 52-109. This evaluation took into consideration the Company's disclosure policy, a cascading certification process and the presence of the disclosure committee. Based on that evaluation, the President & CEO and the CFO concluded that the design and operation of our disclosure controls and procedures were effective as at December 31st, 2008.

12.2. Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance to GAAP.

Internal control over financial reporting includes policies and procedures which pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions; provide reasonable assurance that transactions are recorded as necessary, thereby permitting preparation of consolidated financial statements in accordance with determined authorizations; and provide reasonable assurance regarding prevention or timely detection of unauthorized use of our assets that could have a material effect on our consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of our internal control over financial reporting to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

As of December 31st, 2008, management evaluated the design of internal control over financial reporting as defined under MI 52-109, and, based on that evaluation, determined that certain aspects of internal control over financial reporting were not designed effectively but were mitigated by additional procedures to compensate them. As part of the conducted evaluation, the Company has continued to implement entity level controls which are now in accordance with COSO control framework. This results in a much greater level of confidence in the mitigating controls to compensate for the identified weakness. The control deficiencies identified by the Company did not result in adjustments to our consolidated financial statements for 2008. Management's assessment identified the following material weaknesses along with related remediation:

12.2.1. Entity level controls

During the fourth quarter of 2008, The Company has ensured its entity level controls were now maintained in accordance with COSO control framework. The entity level controls have considerably evolved during the financial year, but considering that the Company went through significant growth in the last years, changing considerably the environment, increasing substantially its assets and number of employees, and consequently creating a need for clear policies and procedures, there is a need for continued improvement on the control environment. We do have several written policies and procedures that are communicated and always available to employees; but some policies need to be reviewed as the business continuously evolves.

To mitigate that risk, management has been very active in:

- Communication to employees and management of their roles & responsibilities with regards to internal control over financial reporting;
- Production of bi-weekly management reports;
- Bi- weekly management committee meeting;
- Bi-weekly disclosure committee meeting (included in management committee meeting);
- Full-time availability of all policies and procedures to employees, managers, and directors;
- Evaluation of the design of the internal controls and continuous implementation of additional controls to ensure an increased level of confidence;

- Monthly financial statements are established by the Chief Accountant, and reviewed and analyzed by all vice-presidents and the President and CEO. With the financial statements, an analytic review is provided in order to explain variances between actual and budget.
- Quarterly financial statements are reviewed and annual financial statements are audited by external auditors. These statements, along with all related documents, are reviewed by members of the audit committee and approved by the board of directors.

As a conclusion, the Company will communicate with the different consolidated subsidiaries' presidents and controllers the results of the evaluation conducted in 2008 and will proceed with implementing the required additional controls to ensure an even better control environment.

12.2.2. Segregation of duties

The Company had deficient controls within its accounting and finance department relating to segregation of duties inherent to its size. Specifically, as a result of the limited number of personnel in the accounting and finance department, certain financial personnel had incompatible duties that allowed for the creation, review and processing of certain financial data without independent review and authorization.

To mitigate that risk, we continue to implement improved monitoring systems, other procedures to prevent occurrence of frauds, properly assign roles and responsibilities to employees to maximize segregation of duties within the limited environment, and rely on procedures and controls as described in the previous section (see 14.2.1 "Entity level controls").

It should be noted that some of the weaknesses mentioned above are related to the size of the Company and to integration of the acquired Pure Group companies during the past year. Management is nevertheless committed to establishing effective internal controls over financial reporting and as such will continue to refine existing controls and implement additional controls as deemed necessary.

13. SELECTED RISKS

This section presents the most important risks associated with ProSep's business operations and is periodically reviewed by Management and overseen by the Board of Directors. During the quarter ended June 30, 2009 risks and proposed remedies and risk management practices have not materially changed. Refer to the previous interim and 2008 annual MD&A for a complete list of risks and proposed remedies.



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ProSep Inc. is traded on the Toronto Stock Exchange under the symbol "PRP"