

Consolidated Financial Statements

**Thermal Energy International Inc.**

May 31, 2005

## Auditors' Report

To the shareholders of  
Thermal Energy International Inc.

We have audited the consolidated balance sheets of Thermal Energy International Inc. as at May 31, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Raymond Chabot Grant Thornton LLP*

Chartered Accountants

Ottawa, Canada  
September 2, 2005

**THERMAL ENERGY INTERNATIONAL INC**  
 Incorporated under the Ontario Business Corporations Act

**CONSOLIDATED BALANCE SHEET**

As at May 31

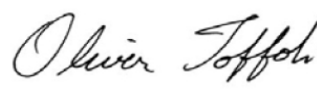
	2005 \$	2004 \$
<b>ASSETS</b>		
<b>Current assets</b>		
Cash	174,218	261,296
Short term investments (note 6)	800,263	-
Accounts receivable (note 7)	231,259	251,175
Contracts in progress	65,000	-
Prepays and other assets	7,611	1,414
	<u>1,278,351</u>	<u>513,885</u>
Loan receivable (note 10)	-	2,000
Property, plant and equipment (note 11)	35,778	29,063
	<u>1,314,129</u>	<u>544,948</u>
<b>LIABILITIES, CAPITAL STOCK, CONTRIBUTED SURPLUS AND DEFICIT</b>		
<b>Current liabilities</b>		
Accounts payable	411,301	813,289
Accrued liabilities	318,450	146,785
Deferred revenue	474,000	103,200
Due to past President (note 9)	300,972	334,001
	<u>1,504,723</u>	<u>1,397,275</u>
<b>Capital stock, contributed surplus and deficit</b>		
Capital stock (note 14)	12,625,487	10,856,803
Contributed surplus (note 14)	1,237,995	166,150
Deficit	(14,054,076)	(11,875,280)
	<u>(190,594)</u>	<u>(852,327)</u>
	<u>1,314,129</u>	<u>544,948</u>

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

On behalf of the Board



President & CEO



CFO

**THERMAL ENERGY INTERNATIONAL INC**

**CONSOLIDATED OPERATIONS AND DEFICIT**

Year ended May 31

	2005	2004
	\$	\$
<b>REVENUE</b>		
Sales	668,204	922,510
Cost of sales	485,474	719,676
<b>Gross profit</b>	<b>182,730</b>	<b>202,834</b>
<b>Expenses</b>		
Administration	520,818	371,668
Financing fees	-	64,593
Selling, marketing and business development	574,034	618,054
Stock-based compensation expense (note 3 and 15)	397,673	49,500
Legal fees	52,450	67,377
Audit fees	63,050	52,422
Insurance	105,694	102,277
Amortization of property, plant and equipment	9,150	11,202
Patent and trademark maintenance	22,696	38,087
Research and development	2,550	4,311
Amortization of patents and trademarks (note 3 and 12)	-	32,573
Impairment loss (notes 3 and 12)	-	127,539
Interest and bank charges	11,832	35,964
Foreign exchange loss (gain)	(16,522)	10,649
	1,743,425	1,586,216
	(1,560,695)	(1,383,382)
Other revenue (note 8)	87,906	206,106
Loss before taxes	(1,472,789)	(1,177,276)
Future income tax recovery (note 16)	51,200	-
<b>Net loss</b>	<b>(1,421,589)</b>	<b>(1,177,276)</b>
Deficit, beginning of year	(11,875,280)	(10,698,004)
	(13,296,869)	(11,875,280)
Change in accounting policy (note 3)	(757,207)	-
<b>Deficit, end of year</b>	<b>(14,054,076)</b>	<b>(11,875,280)</b>
Net loss per share - basic and diluted	(0.03)	(0.03)
Weighted average number of common shares	54,826,526	42,676,061

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

**THERMAL ENERGY INTERNATIONAL INC****CONSOLIDATED STATEMENT OF CASH FLOWS**

Years ended May 31

	2005	2004
	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net loss for the year	(1,421,589)	(1,177,276)
Add items not involving cash:		
Financing fees earned by the past President (note 9)	-	64,593
Non-monetary compensation charge	397,673	49,500
Amortization of property, plant and equipment	9,150	11,202
Amortization of patents and trademarks	-	32,573
Future income taxes	(51,200)	-
Impairment loss	-	127,539
Changes in non-cash operating working capital (note 5)	89,196	(92,361)
Changes in due to the past President (note 5)	(33,029)	138,488
Net cash used in operating activities	(1,009,799)	(845,742)
<b>INVESTING ACTIVITIES</b>		
Additions to short term investments	(800,263)	-
Decrease in loan receivable	2,000	10,312
Additions to patents	-	(12,929)
Additions to plant and equipment	(15,865)	(7,120)
Net cash used in investing activities	(814,128)	(9,737)
<b>FINANCING ACTIVITIES</b>		
Common shares issued (note 14)	1,736,849	1,059,311
Share issue expenses	-	(11,662)
Cash financing provided by the past President	-	23,000
Net cash provided by financing activities	1,736,849	1,070,649
Increase (decrease) in cash for the year	(87,078)	215,170
Cash beginning of year	261,296	46,126
Cash end of year	174,218	261,296
Interest paid	11,832	34,743

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

# THERMAL ENERGY INTERNATIONAL INC.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 1 GOVERNING STATUTES AND NATURE OF OPERATIONS

The Company was incorporated under the Ontario Business Corporations Act on May 22, 1991 and is primarily engaged in the development, engineering and supply of pollution control and heat recovery systems.

### 2 GOING CONCERN

The Company incurred losses from operations in years past and current and had a working capital deficiency and shareholders' deficiency as at May 31, 2005 and 2004.

The Company's ability to meet its obligations as they fall due is dependent upon any combination of the following: the continued financial support of its shareholders, its ability to arrange long-term financing and its ability to generate sufficient cash from operations.

The financial statements have been prepared on the going concern basis, which assumes the realization of assets and the satisfaction of liabilities in the normal course of business. These financial statements do not include any adjustments to the carrying value or classification of assets and liabilities, nor to the results of operations, should the Company not continue to operate as a going concern.

Management is of the opinion that sufficient funds will be available from operations, external financing, and the continued financial support of its principal shareholders to meet the Company's liabilities and commitments as they become due.

### 3 CHANGES IN ACCOUNTING POLICIES

Effective June 1, 2004, the Company adopted the new Canadian standard for "Stock-based Compensation and Other Stock-based Payments", which requires that fair-value method of accounting be applied to all stock-based compensation payments for both employees and non-employees. Under the fair-value based method, compensation cost is measured at fair value at the grant date and is expensed over the awards vesting period. The transitional provisions of the standard allow the Company to adopt this method retroactively without restatement of prior periods. Accordingly, this retroactive application impact increased the opening deficit and opening contributed surplus by \$757,207 respectively, and increased current year net loss by \$391,673.

In March 2004, the CICA issued Emerging Issue Committee Abstract no 146 (EIC-146) Flow-through Shares, which applies to flow-through share issuances initiated after March 19, 2004. The Corporation adopted prospectively the new recommendations and now records the tax effect related to renounced deductions on the date that the Corporation renounced the deductions to investors. The impact of this change resulted in a decrease in share capital of \$51,200. The recognition of the portion of the previously unrecognized future income tax asset resulted in a tax recovery of \$51,200.

In July 2003, the Canadian Institute of Chartered Accountants published section 1100 titled Generally Accepted Accounting Principles and section 1400 titled General Standards of Financial Statement Presentation, that apply to fiscal years beginning on or after October 1, 2003. Section 1100 establishes standards for financial reporting in accordance with generally accepted accounting principles. It describes what constitutes Canadian generally accepted accounting principles and its sources. This Section also provides guidance on sources to consult when selecting accounting policies and determining appropriate disclosures, when a matter is not dealt with explicitly in the primary sources of generally accepted accounting principles. Section 1400 provides guidance on the concept of fair presentation in accordance with generally accepted accounting principles. These new standards did not have any impact on the financial situation or the operations of the Company.

On June 1, 2003, the Company adopted, on a prospective basis, the recommendations in the Canadian Institute of Chartered Accountants Handbook Section 3063 titled Impairment of Long-lived Assets. This section recommends that companies recognize an impairment loss when the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. The recoverability of the carrying amount is determined using estimates of future cash flows that are expected to arise as a direct result of the asset's use and eventual disposition. The Company, in the application of this standard to its patent and trademark assets is unable to forecast future cash flows since this will depend on proving and developing the technology. This development has been hindered by lack of resources available to the Company, however management strongly believes that the technology has significant potential and the Company will continue to support it by maintaining the patents and trademarks in those countries where most of this potential lies. Since future cash flows cannot be objectively forecast at this time, the Company recognized a write-down of patent and trademark assets of \$127,539 in the year ended May 31, 2004 (note 12).

In February 2003, the Canadian Institute of Chartered Accountants published Accounting Guideline No. 14 titled Disclosure of Guarantees. This guideline presents the views of the Accounting Standards Board on the financial statement disclosures to be made by a guarantor about its obligations under guarantees. The Company has adopted these recommendations effective June 1, 2003. The new recommendations did not have any impact on the financial statements of the Company.

# THERMAL ENERGY INTERNATIONAL INC.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies are as follows:

#### **Basis of consolidation**

The consolidated financial statements of the Company include the accounts of its wholly owned subsidiary, 2003356 Ontario Inc.

#### **Use of estimates**

Since a precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements for a period in conformity with Canadian generally accepted accounting principles necessarily involves the use of estimates and approximations which have been made by management using careful judgment. Actual results could differ from these estimates.

#### **Revenue recognition**

Contract income is recorded under the percentage-of-completion method. Under this method, contract income and profit are recognized proportionately with the degree of completion of work. Degree of completion is determined using the cost-to-cost method, which consists in comparing the costs incurred at the date of the financial statements with the last estimate of the total cost of work to be performed. Contracts in progress are valued considering labour, material and some overhead costs, which include estimated profits. Losses are recorded once they can be estimated. Amounts billed or payments received but not yet earned are deferred until the revenue is earned.

#### **Cash and cash equivalents**

All highly liquid investments with original maturities of three months or less are classified as cash equivalents. Cash and cash equivalents are recorded at cost which approximates fair value.

#### **Amortization**

Property, plant and equipment are recorded at cost. Amortization is computed using the following annual rates and methods:

Furniture and fixtures	20% declining-balance
Computers	3 years straight-line
Software	50% declining-balance
Leasehold improvements	3 years straight-line

#### **Loss per share**

The basic loss per share is calculated on the basis of net loss divided by the weighted average number of common shares outstanding during the year. The diluted per share amount is calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments. The treasury stock method assumes that proceeds received from the exercise of the in-the-money stock options are used to repurchase common shares at the prevailing market rate. The diluted loss per share is equal to the basic loss per share because the effect of dilutive securities is antidilutive.

#### **Income taxes**

The liability method is used to account for income taxes. Future tax assets and liabilities are recognized for tax consequences of temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Future tax assets and liabilities are measured using substantively enacted tax rates in effect for the year in which the differences are expected to be recovered or settled. A valuation allowance is established to reduce the future tax asset if it is not "more likely than not" that the related tax benefits will be realized in the future.

#### **Research and development costs and government assistance**

The Company carries on various research and development programs, and from time to time these are funded by the Government of Canada. Funding received is accounted for using the cost reduction approach and is netted against research or development costs. Research costs are expensed as incurred. Development costs are charged to expense as incurred unless they meet generally accepted accounting criteria for deferral and amortization. No costs have been deferred to date.

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

#### Foreign currency translation

All monetary assets and liabilities denominated in foreign currency are translated into Canadian dollars at the exchange rate in effect at the balance sheet date, whereas other assets and liabilities are translated at exchange rates in effect at transaction dates. Revenues and expenses in foreign currency are translated at the average exchange rate in effect during the period. Gains and losses are included in the earnings for the year.

#### Investment tax credits

Investment tax credits are accounted for under the cost reduction method whereby they are netted against the cost of the property, plant and equipment to which they relate. Investment tax credits are recorded when the Company has incurred qualifying expenditures and there is reasonable assurance the tax credit will be realized.

#### Stock-based compensation

The Company accounts for its grants under stock-based compensation plans using the fair value method and compensation expense is recognized in the period in which the options vest. When holders exercise their options, any consideration received and any contributed surplus related to these options is credited to capital stock.

#### 5 INFORMATION INCLUDED IN THE STATEMENT OF CASH FLOWS

Changes in working capital items are detailed as follows:

	2005	2004
	\$	\$
Accounts receivable	19,916	175,360
Contracts in progress	(65,000)	10,000
Prepays and other assets	(6,197)	19,667
Accounts payable	(401,988)	(267,137)
Accrued liabilities	171,665	(58,543)
Deferred revenue	370,800	28,292
	89,196	(92,361)

The net change in the amount due to the past President is detailed as follows:

	2005	2004
	\$	\$
Due to the past President	(33,029)	(453,269)
	(33,029)	(453,269)
Items presented separately		
Financing fees earned	-	(64,593)
Cash financing provided by the past President	-	(23,000)
Impact of shares issued in settlement of debt	-	679,350
	(33,029)	138,488

#### 6 SHORT TERM INVESTMENTS

The Company has invested cash, surplus to its current requirements, in a cashable guaranteed investment certificate which bears an interest rate of 2.5%, renewable on June 2, 2006.

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**7 ACCOUNTS RECEIVABLE**

	<b>2005</b>	2004
	<b>\$</b>	<b>\$</b>
Trade	<b>184,592</b>	251,175
Other	46,667	-
	<b>231,259</b>	251,175

At May 31, 2005 and May 31, 2004 all trade receivables and revenues were from one customer and were all in Canadian dollars.

**8 OTHER REVENUE**

In fiscal 2005, liabilities were extinguished and the resultant gain of \$87,906 was credited to other revenue.

In fiscal 2004, the Company settled litigation with a customer and certain suppliers. Under terms of the settlement, the customer agreed to pay specific Company liabilities to suppliers in exchange for net settlement of accounts receivable. Liabilities extinguished totalled \$558,882 which was more than the recorded amount of accounts receivable of \$352,776, resulting in a net gain of \$206,106. The resultant gain was recognized as other revenue.

**9 RELATED PARTY TRANSACTIONS**

Related party transactions are measured at exchange value which represents the amounts established and agreed upon by both parties.

	<b>2005</b>	2004
	<b>\$</b>	<b>\$</b>
Transactions with and balances owing to/from directors		
Fees for services	64,500	129,693
Accounts receivable	-	2,000
Accounts payable	-	2,365
Accrued liabilities	49,292	-
Flow-through shares issued	69,944	85,665
Directors share options outstanding at May 31		
Issued	2,650,000	1,533,000
Exercisable	1,650,000	1,533,000
	<b>2005</b>	2004
	<b>\$</b>	<b>\$</b>
Transactions with and balances owing to/from officers		
Fees for services	178,570	63,142
Accounts receivable	2,955	-
Accrued liabilities	7,618	-
Flow-through shares issued	105,622	30,750
Officers share options outstanding at May 31		
Issued	1,143,000	589,000
Exercisable	593,000	589,000

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

Changes to the amounts due to the past President during the year were as follows:

	<b>2005</b>	<b>2004</b>
	<b>\$</b>	<b>\$</b>
Balance due to the past President, beginning of year	<b>334,001</b>	787,270
Financing fees earned	-	64,593
Issuance of shares in settlement of debt owed to the past President	-	(679,350)
Payments made on behalf of past President	<b>(33,029)</b>	-
Cash loans and debts paid by the past President, net	-	161,488
<b>Balance due to the past President, end of year</b>	<b>300,972</b>	<b>334,001</b>

Amounts due to the past President have no fixed repayment terms and are non-interest bearing. The number of common shares issued in settlement of liabilities was determined with reference to the fair value of shares at the date of issuance, resulting in no gain or loss on the settlement.

**10 LOAN RECEIVABLE**

	<b>2005</b>	<b>2004</b>
	<b>\$</b>	<b>\$</b>
Loan receivable from a Director	-	2,000

This loan was due on demand, bore no interest and had no fixed repayment terms.

**11 PROPERTY, PLANT AND EQUIPMENT**

	<b>2005</b>		<b>2004</b>	
	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Cost</b>	<b>Accumulated Amortization</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Furniture and fixtures	<b>78,351</b>	<b>53,194</b>	68,318	49,610
Computers	<b>136,382</b>	<b>127,861</b>	130,549	124,585
Software	<b>12,081</b>	<b>9,981</b>	12,081	7,690
Leasehold improvements	<b>54,548</b>	<b>54,548</b>	54,548	54,548
	<b>281,361</b>	<b>245,583</b>	265,496	236,433
Accumulated amortization	<b>(245,583)</b>		(236,433)	
<b>Net book value</b>	<b>35,778</b>		29,063	

**12 PATENTS AND TRADEMARKS**

In fiscal 2004, Management evaluated the carrying value of its patents and trademarks and, since recovery from future cash flows could not be objectively measured at that time, it was decided to record a write-down in the carrying value of the assets of \$127,539 (note 3).

In fiscal 2004, amortization of \$32,573 included \$10,256 related to patent and trademark abandonment.

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**13 COMMITMENTS**

The Company is committed under the terms of operating leases for premises and office equipment contracts with various expiry dates in the following amounts:

	\$
2006	71,400
2007	9,800
2008	4,400
2009	3,600
2010	2,100
Total	91,300

**14 CAPITAL STOCK AND CONTRIBUTED SURPLUS**

	2005		2004	
	# Shares	\$	# Shares	\$

**Authorized**

Unlimited number of Class A common shares, no par value  
 Unlimited number of Series 1 preferred shares, voting only in the case of dissolution of the Company, redeemable at the option of the Company  
 1 convertible to common shares on a 1 to 1 basis  
 at the rate of 20% of the number originally issued per year.

**Class A Common shares issued**

Balance, beginning of year	50,947,118	11,008,303	35,511,949	9,281,304
Issued in settlement of liabilities, net of issue costs	2,523,750	261,496	10,659,669	1,129,036
Issued for cash, net of issue costs	9,103,031	1,328,153	4,775,500	597,963
Issued as a result of the exercise of options	625,000	179,035		
	63,198,899	12,776,987	50,947,118	11,008,303
Less: loans outstanding to assist a shareholder in purchasing capital stock (i)		(151,500)		(151,500)
Balance, end of year	63,198,899	12,625,487	50,947,118	10,856,803

(i) The past President received shareholder loans of \$151,500 to purchase shares during 1999. These loans are due upon demand, bear no interest and have no fixed repayment terms.

In fiscal 2004 and 2005 the Company completed private placements. The funds were raised by issuing Units that included one Class A common share and one non-transferable share purchase warrant. Given the inherent subjectivity of evaluating the warrants, the Company determined it preferable to attribute the full amount of the proceeds to the issued shares.

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

The following table summarizes the status of warrants outstanding at May 31, 2005:

Warrants Outstanding	Exercise Price \$	Expiry Date
383,000	0.14	December 30, 2005
695,000	0.14	January 12, 2006
1,665,000	0.16	March 18, 2006
400,000	0.16	July 21, 2006
3,783,335	0.10	To November 4, 2005, and
	0.20	To November 4, 2006
2,292,030	0.15	To January 18, 2006, and
	0.60	To January 18, 2007
2,806,333	0.50	To June 19, 2007, and
	0.75	To June 19, 2008
12,024,698		

In accordance with the terms of the Company's flow-through share offerings, and pursuant to certain provisions of the Income Tax Act (Canada), the Company is committed to renounce, for income tax purposes, start-up phase expenditures of renewable and energy conservation projects to purchasers of its flow-through shares. During fiscal 2005, the Company renounced approximately \$556,654 (2004 - \$757,882) of expenditures. At May 31, 2005, \$430,582 (2004 - \$464,842) of expenditures are required to be incurred before December 31, 2005. Participation in this program is subject to verification by tax authorities with respect to the nature and timing of expenditures.

**Contributed surplus**

	2005 \$	2004 \$
Balance, beginning of year	166,150	116,650
Change in accounting policy (note 3)	757,207	
Stock-based compensation	397,673	49,500
	1,321,030	166,150
Fair-value of options exercised and transferred to capital stock	83,035	
Balance, end of year	1,237,995	166,150

**15 SHARE OPTION PLAN**

The Company established the Company's Share Option Plan applicable to Directors, Officers and full-time and part-time employees of the Company. In the plan, the aggregate number of options may not exceed 20% of the outstanding shares and the total number of shares to be optioned to any optionee may not exceed 5% of the number of issued and outstanding shares as at the option granting date. The options are granted with an exercise price equal to the market value of the common shares of the Company at the date of grant, less any permissible discounts, and may be exercised at any time after the vesting date, not to exceed five years from the date of granting. Vesting period for options granted is at the discretion of the Board of Directors. Options granted in fiscal 2005 and 2004 had vesting periods ranging from four to six months.

(a) Activity in stock options was as follows:

	2005		2004	
	# Options	Weighted Average \$	# Options	Weighted Average \$
Outstanding, beginning of year	6,512,714	0.22	5,461,228	0.22
Granted	5,218,000	0.16	3,475,714	0.16
Exercised	(625,000)	0.15	-	-
Cancelled/expired	(4,062,000)	0.19	(2,424,228)	0.21
Outstanding, end of year	7,043,714	0.19	6,512,714	0.19
Number of options exercisable as at May 31	4,943,714		6,237,714	

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

In fiscal 2005 there were no reissued options. In fiscal 2004, the Company cancelled 775,714 options with an average exercise price of \$0.18 and reissued 775,714 options with an exercise price of \$0.18.

Options exercised during the year were as follows:

	2005		2004	
	# shares	\$	# shares	\$
Employees	150,000	22,500	-	-
Directors	400,000	60,000	-	-
Consultants	75,000	13,500	-	-
	<b>625,000</b>	<b>96,000</b>	-	-

In 2005, all options were exercised for cash.

(b) The following options are outstanding and/or exercisable at May 31, 2005:

Number of Options Outstanding	Number of Options Exercisable	Exercise Price Per Share \$	Expiry Date
1,300,000	1,300,000	0.18	June 6, 2005
1,050,000	1,050,000	0.15	January 16, 2007
675,714	675,714	0.18	January 16, 2007
100,000	100,000	0.15	May 1, 2007
200,000	200,000	0.10	January 1, 2008
318,000	318,000	0.10	January 12, 2008
100,000	100,000	0.13	January 20, 2008
200,000	200,000	0.12	January 20, 2008
250,000	250,000	0.20	January 24, 2008
1,000,000	500,000	0.10	February 1, 2008
500,000	250,000	0.12	February 1, 2008
150,000		0.24	March 1, 2008
950,000		0.22	April 29, 2008
250,000		0.24	May 19, 2008
<b>7,043,714</b>	<b>4,943,714</b>		

c) Stock-based compensation to employees

Had the Company applied the fair value based method to stock options granted to employees in the 2004 fiscal year, reported net loss per common share would have been increased to the pro-forma amounts indicated below.

	2004 \$
Net loss - as reported	(1,177,276)
Pro-forma stock option expense	(226,000)
<b>Net loss - pro-forma</b>	<b>(1,403,276)</b>
Basic and diluted loss per common share as reported	(0.03)
Pro-forma stock option expense per common share	(0.01)
<b>Basic and diluted loss per common share - pro-forma</b>	<b>(0.04)</b>

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

The fair value of options granted was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

	2005	2004
Weighted average assumptions:		
Expected dividend	0.00%	0.00%
Expected volatility	113%	131%
Risk-free interest rate	3.75%	3.75%
Expected option life in years	2.4	2.4

The weighted average fair value of the Company's stock options, calculated using the Black-Scholes option pricing-model, granted during the two years ended May 31, 2005 and May 31, 2004 were \$0.21 and \$0.11, respectively.

(d) Stock-based compensation to non-employees

Stock-based compensation expense in the current fiscal year includes an amount of \$6,000 for options granted to consultants.

During fiscal 2004, the Company issued 450,000 options to suppliers in consideration for services rendered. The Company used the Black-Scholes option pricing model to estimate the fair value of the compensation to non-employees, using the weighted average assumptions described in (c) above.

**16 INCOME TAXES**

The Company's effective tax rate differs from the combined federal and provincial income tax rate in Canada. This difference comes from the following items:

	2005	2004
	\$	\$
Loss before taxes	(1,472,589)	(1,177,276)
Income taxes calculated using the combined federal and provincial income tax rate in Canada of 36.12% (2004 – 38.12%)	(531,900)	(448,800)
Unrecognized future income tax assets	141,200	183,800
Stock-based compensation	143,600	18,900
Renounced expenditures	191,300	235,600
Non-deductible expenses and other items	12,000	20,700
Share issue expenses deducted	(7,400)	(10,200)
<b>Future income tax provision (recovery)</b>	<b>(51,200)</b>	<b>-</b>

The future income tax assets and liabilities result from differences between the carrying amount and the tax basis of the following:

	2005	2004
	\$	\$
Future income tax assets		
Non-capital losses	2,198,000	2,230,000
Property, plant and equipment	84,000	85,000
Share issue costs	11,000	22,000
	<b>2,293,000</b>	2,337,000
Valuation allowance	(2,293,000)	(2,337,000)
Net future income taxes	-	-

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The Company has financed part of the start-up phase of renewable energy and energy conservation projects through the issuance of flow-through shares. Under the terms of the flow-through share agreements, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregoing tax benefits to the Company, the carrying value of the shares issued is reduced by the tax effect of the tax benefits renounced to subscribers. The tax effect of the renouncement is recognized on the date the Company files the renouncement documents with the tax authorities to renounce the tax credits associated with the expenditures, provided there is reasonable assurance that the expenditures will be made.

The Company has not recorded the potential benefit of income tax loss carry forwards in the consolidated financial statements. As at May 31, 2005, the Company had available income tax loss carry forwards in the following amounts which may be used to reduce federal and provincial taxable income.

<b>Year of Expiry</b>	<b>Amount</b>
	<b>\$</b>
2006	735,000
2007	2,027,000
2008	-
2009	1,086,000
2010	1,395,000
2014	355,000
2015	533,000
<b>Total</b>	<b>6,131,000</b>

#### 17 SEGMENTED INFORMATION

The Corporation operates in one operating segment – energy conservation and environmental compliance (air). Within this business segment, the Corporation markets, sells, engineers, fabricates, constructs, installs and supports two retrofit technology lines – waste energy recovery solutions and air pollution control solutions. Revenue is derived mainly from engineering and constructing the complete retrofit energy recovery and air pollution control solution, with some revenue derived from the custom fabrication and assembly of the proprietary hardware components and the core major equipment package of the technologies. All assets are located in Canada.

One unaffiliated customer accounted for 100% of sales in 2005 and in 2004. The Company is working aggressively with other potential partners to attract new customers.

#### 18 FINANCIAL INSTRUMENTS

Given that they will mature shortly, the carrying values of the Company's short-term financial instruments are equivalent to their carrying amounts.

The Company is exposed to foreign exchange risk due to accounts payable denominated in U.S. dollars. As at May 31, 2005, accounts payable denominated in U.S. dollars totalled US\$56,561 (US\$124,906 at May 31, 2004).

The Company does not enter into arrangements to hedge its foreign exchange risk.

#### 19 SUBSEQUENT EVENTS

In March 2005, a resolution of the Board of Directors cancelled a convertible debenture issued in July 2004 with a face value of \$376,704. After review by the past President, creditors and the Company in June 2005, agreement was reached to reduce the resulting obligations to \$50,000 and a cheque for this amount was issued to the past President in August 2005.

#### 20 COMPARATIVE AMOUNTS

Certain 2004 amounts have been reclassified to conform with the current year's presentation.