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# ANNUAL REPORT TO SHAREHOLDERS

FISCAL YEAR END  
MAY 31, 2009

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An Innovative Technology Company Providing  
Custom Energy & Energy Emission Reduction Solutions





## TABLE OF CONTENTS

President's Message . . . . .	3
Management's Discussion and Analysis . . . . .	4
Management Responsibility Statement . . . . .	10
Auditors' Report. . . . .	10
Consolidated Financial Statements . . . . .	11
Notes to the Consolidated Financial Statements . . . . .	15
Information for Shareholders . . . . .	25

## DISCLAIMER

This annual report may contain forward-looking statements relating to, and among other things, based on management's expectations, estimates and projections.

Such statements including those about the Company's strategy for growth, product development, market position, expected expenditures and financial results are forward looking statements.

These statements are not guarantees of future performance and involve a number of risks, uncertainties and assumptions. Many factors could cause results to differ materially from those stated.

The Company disclaims any obligation to publicly update or revise any such statements.





## PRESIDENT'S MESSAGE

When I joined the Board of Directors of Thermal Energy in 2007, I was very pleased to be joining a company with such enormous potential. What I saw in Thermal Energy was a highly dedicated, loyal and passionate group of employees with exceptional technical capabilities; a suite of unique, proprietary and proven energy and emission reduction technologies; and a potential market with strong and improving economic, regulatory and social fundamentals. And now, two years later, as CEO, I am even more confident in Thermal Energy's ability to succeed. In short we have the right people, with the right products in the right market.

To be sure, the Company's financial results in fiscal 2009 were below expectations but this is in the context of a collapse of energy prices and the worst economic recession since the Great Depression. Last year, at the end of fiscal 2008, oil prices were in the \$130 per barrel range. By the end of fiscal 2009 oil was trading near \$65 per barrel after hitting a low of \$30 per barrel in December 2008. Clearly these were not the sort of conditions conducive to success for a company in the energy efficiency business. But conditions have already improved significantly and the market consensus and opinions of our customers are unanimous, long term energy prices are expected to continue to climb. Add to this a steadily improving regulatory environment and a strong government focus on alternative energy and energy conservation initiatives worldwide (since July 2008 over 250 government policies have allocated more than \$400 billion to alternative energy and energy conservation) and you have the makings of a solid recovery that is already beginning to be reflected in renewed demand for, and interest in, our products.

Thermal Energy achieved a number of important milestones in fiscal 2009 which collectively solidify our position as a diversified global energy services company including:

- Closing an oversubscribed brokered private placement of common shares with gross proceeds of \$15,000,000. This placement was the largest in the Company's history and was subscribed to by a number of renewable energy and sustainability focused funds in Canada, United States and Europe thereby providing the Company a strong cross border shareholder base and excellent international exposure.
- Completion of the acquisition of Gardner Energy Management Ltd. of Bristol, U.K and its unique GEM venture orifice steam trap. This acquisition provides Thermal Energy a number of significant strategic and market synergies, including: an excellent complementary fit with Thermal Energy's existing products, a European base of operations and sales force, a strong customer list of multinational companies, a shorter sales cycle, and a more consistent revenue stream.
- Building out our international sales network. Since our 2008 fiscal year end, Thermal Energy has added sales staff and agents in Canada, United States, United Kingdom, Ireland, Germany, Italy, Belgium, The Netherlands, Scandinavia, China, India, Malaysian, Australia and the Middle East.

Subsequent to year end Thermal Energy concluded an agreement with Kemco Systems Inc of Clearwater, Florida to become the exclusive distributor of Kemco products in all areas globally except North and South America. Kemco has a 30 year track record of providing high efficiency, environmentally friendly water heaters, heat recovery products, and water treatment systems to the laundry, textile, food & beverage, ready mix concrete, automotive and other industries. All of these industries are a strong overlap of Thermal Energy's existing customer base.

The acquisition of Gardner Energy Management Ltd. and the exclusive distribution

rights for the Kemco product line enhances Thermal Energy's broad suite of complementary water, energy and emission saving products. This, together with the additions to our international sales network, places Thermal Energy in an excellent position to capitalize on the growing global trend of energy and water efficiency.

Despite this positive outlook however, I am very aware that the last few months have been a particularly difficult and frustrating time for employees and shareholders alike. I would like to thank all of our shareholders, employees and customers for their continued steadfast support of the Company during this trying time.

I would also like to thank John Parker, Tim Angus, Clint Sharples and Oliver Toffoli for all their hard work and dedication over the last several years. Under their leadership the company has undergone a very significant positive transition from a single product regional player to a multi product global company. It is through these efforts that seeds of future success have been sown.

Finally I would like to thank Thermal Energy's Board of Directors and employees for welcoming me into the role of CEO and trusting me with the Company's future growth.

I am confident there are very exciting times ahead for Thermal Energy and I look forward to earning the confidence and respect of all stakeholders.

Sincerely,



William Crossland  
President and Chief Executive Officer

# MANAGEMENT'S DISCUSSION & ANALYSIS

## Overview

This discussion explains the material changes in Thermal Energy International Inc.'s ("Thermal Energy" or the "Company") financial condition and results of operations for the fiscal year ended May 31, 2009 (or FY 2009), and compares the FY 2009 financial results to the previous year ended May 31, 2008 (or FY 2008). The consolidated financial statements, and notes to the consolidated financial statements constitute an integral part of the discussion and should be read in conjunction with these comments. This discussion and analysis of the financial condition and results of operations may contain forward-looking statements. These statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

Thermal Energy has established itself since 1991 as an innovative technology company providing custom energy and emission reduction solutions. Our award winning energy recovery, conservation, bioenergy and condensate return solutions provide significant financial and environmental benefits to our customers.

Thermal Energy engages clients through a unique mix of process, energy, environmental, financial and other expertise combined with the best technology solutions and financial offerings. The Company's client can expect compelling returns and solutions with an excellent track record of longevity, proven reliability and performance.

More information on Thermal Energy can be found at [www.thermalenergy.com](http://www.thermalenergy.com). FLU-ACE®, THERMALONOX™, DRY-REX™ and GEM™ are trademarks of Thermal Energy. Common shares of Thermal Energy are traded on the TSX Venture Exchange under the symbol TMG.

## Environmental Compliance and Energy Conservation Market

### Trends

World market demand is increasing for innovative environmental protection and renewable energy solutions for sustainable economic growth. North America today is faced with the growing challenge of reducing and controlling air pollution emissions that cause serious health risk to human beings, cross international borders, and impact the environment. Furthermore, as the United States, Canada, Europe ("EU"), and China strive to grow their economies and increase their economic outputs, this causes increased demand and consumption of fossil fuels. Therefore, the more successful a country becomes, the larger the task and costs are for the reduction and the control of multiple air pollutant emissions from fossil fuel consumption. In addition, the costs of oil and natural gas fossil fuel energy sources have been rising substantially both due to the increasing demand for their utilization, and due to the decreasing fossil fuel reserves and sources which are available for consumption. Thermal Energy has developed and commercialized a number of proprietary energy and emission reduction technologies and solutions, designed specifically to cost-effectively reduce our customers energy use and emissions.

Thermal Energy is well positioned to provide the United States, Canada, EU, and China with the best available products, technologies, and solutions to most economically meet both the medium-term and longer-term energy conservation objectives. In order to leverage the sales of its proprietary technologies worldwide Thermal Energy continues to develop a number of strategic alliances, cooperative partnerships, and synergistic sales agencies and agreements with companies in all of its key markets.

## Energy Conservation and Environmental Compliance Solutions Business

Thermal Energy's technologies have widespread industrial, utility, commercial and institutional applications for environmental compliance, self-funding energy retrofits and infrastructure upgrades to plant operations. Specifically the technologies can be applied to process modifications and retrofit solutions for primary metal processing, automotive manufacturing, coal-fired power utility, petrochemical, pulp & paper, and food processing industries as well as for sewage treatment, central or district heating, commercial building, and institutional facilities. In addition, Thermal Energy has developed leading edge energy-from-waste solutions for combustion of

solid and liquid waste via incineration and thermal destruction facilities.

The Company delivers superior proprietary and patented environmental compliance and energy conservation technologies coupled with comprehensive engineering and implementation services.

Thermal Energy's core business provides three primary client benefits:

1. Energy consumption & cost reduction;
2. Commensurate greenhouse gas and emission reductions;
3. Excellent financial returns.

The Company provides this through two core focus areas:

1. Energy Solutions
2. Environmental research and development

Energy Solutions: The Companies energy solutions portfolio comprises three primary technologies:

- **FLU-ACE® waste heat recovery:** This proprietary technology was developed by Thermal Energy to recover 75% or more of the heat wasted through exhausts. FLU-ACE® systems are designed to process exhaust gas from combustion of all fuel types, plus process exhaust from dryers such as from pulp and paper, and food and beverage industries. This waste heat is captured as condensed hot water and returned to process which displaces the use of fossil fuel and reduces energy costs with commensurate emission reductions.
- **DRY-REX™ low temperature biomass dryer:** This patented technology was acquired in 2006. DRY-REX™ dries large quantities of biomass and biowaste at relatively low temperature. It can recover energy from "waste" heat sources and reduces air quality concerns. It turns waste such as bark and sludge into high quality biofuels.
- **GEM® Condensate Return System:** The GEM® Condensate return System is a permanent replacement for traditional, mechanical steam traps. GEM® results in lower steam production costs, lower greenhouse gas emissions and improved steam efficiency. Thermal Energy acquired GEM in June 2008.

**Environmental Research and Development:** Thermal Energy is currently engaged in research and development of the THERMALONOX™ technology for reducing nitrogen oxide emissions (NOx) from coal-fired power plants and other industrial sources. A joint venture is under way at the South China University of Technology (SCUT), supported by Chinese government agencies, to establish a pilot demonstration facility which is expected to lead to the eventual commercialization of THERMALONOX™.

More information may be found on the Company's products, technologies and solutions by visiting the website at [www.thermalenergy.com](http://www.thermalenergy.com).

Throughout FY 2009 the Company maintained its close working relationship with Johnson Controls L.P. ("JCI") for developing combined energy conservation and air pollution control solutions for their selected Canadian and U.S. customers.

In FY 2008 the Company through its wholly-owned subsidiary, ForEverGreen Energy Inc. (FEI), implemented a 6 year contract with Fraser Paper Inc.'s Thurso mill for the delivery of "green" energy. Thermal Energy continues with monthly invoicing to the customer for the supply of green energy. However, the Thurso mill was temporarily shut down at the beginning of Q1 FY 2010 for an undetermined period of time and presents some risk to the Corporation if it does not re-open or at worse if Fraser Paper Inc. files for bankruptcy.

The Company was successful in financing its working capital requirements to support its business development efforts, by raising capital through the completion of a brokered private placement. The private placement with gross proceeds of \$15,000,000 closed on June 21, 2008. The financing consisted of the issuance of 68,181,818 common shares at \$0.22 per share. The funds raised were to complete the acquisition of Gardner Energy Management Ltd. in the U.K. (requiring approximately CAD\$5.4 M) and to provide the Corporation a funding base for future investment in its business.

The Company incurred a net loss during the year of \$3,205,377 compared to \$2,372,508 during the previous year and has an accumulated deficit at year-end of \$24,209,973. The Company's ability to continue as a going concern has improved by obtaining a significant level of financing in the amount of \$15M through a brokered

private placement in Q1 FY2009 but will continue to improve only by executing new solution sales contracts that results in achieving or exceeding targeted gross margins.

## Revenues and Gross Profits

Revenues were \$3,958,922 in FY 2009 compared to \$4,926,208 in FY 2008. Revenues decreased by 19.6% in FY 2009 compared to FY 2008 due to a reduced carry-over volume of revenue from the previous year and without new secured solution sales.

The gross profit of \$2,363,629 in FY 2009 improved substantially from a gross profit of \$608,024 in FY 2008. These results expressed as a percentage of sales were 59.7% in FY 2009 compared with 12.3% in FY 2008. The current year profit was due to the additional revenue stream from consolidating the newly acquired GEM Ltd.

## Expenses

Administration expenses in FY 2009 were \$2,033,475 compared with \$1,228,984 in FY 2008. The increase was due mainly to GEM administration costs of \$692,528. Other increases arose in general administration and salary increases.

Selling, marketing and business development expenses were \$3,036,714 in FY 2009 compared to \$1,314,208 in FY 2008, an increase of \$1,722,506 or 231.10%. The major changes were GEM costs of \$1,557,519 and increases due to the hiring of new sales personnel with associated costs of approximately \$335,000, severance costs of \$99,950 and offset by a reduction of \$152,921 in stock-based compensation.

Legal expenses in FY 2009 were \$90,459 including \$28,076 from GEM, and combined was a significant decrease compared to the amount of \$331,836 incurred in FY 2008. The greater expenses of the previous year were one time charges related to the litigation by the past President and CEO against the Company and \$120,000 and legal costs by U.K. lawyers in assisting with the acquisition of GEM Ltd.

Audit expenses in FY 2009 were \$55,794 including \$27,038 from GEM and compared to \$72,839 in FY 2008. The apparent reduction in fees is a result of not recognizing audit fees related to FY 2009 until these are actually incurred.

Insurance expenses were \$119,274 in FY 2009 including \$16,359 from GEM and compared with \$127,993 in FY 2008 due to a reduction in premiums and a gain on settlement with a supplier of \$15,445.

Patent and trademark maintenance costs were \$18,151 in FY 2009 compared to \$13,587 in FY 2008 with respect to countries where patents have been granted. Patent and trademark maintenance costs are expensed as incurred. The increase in costs year over year was due to costs of \$1,060 from GEM and additional reporting requirements pending the testing of the Company's THERMALONox™ technology.

Research and Development costs increased in FY 2009 to \$204,880 compared to \$87,572 in FY 2008. The increase was due to costs of \$13,115 from GEM and equipment purchases and the costs for the container shipment of the equipment to China.

Amortization of property, plant and equipment was \$51,220 in FY 2009 including \$21,466 from GEM and compared with \$31,314 in FY 2008.

Amortization of intangible assets was \$170,958 in FY 2009. These assets were acquired on the purchase of Gardner Energy Management Ltd. and represent the amortization of the estimated useful life of these assets since the acquisition.

## Interest revenue

Interest revenue of \$77,891 in FY 2009 compared to \$32,098 in FY 2008 resulting from higher levels of short-term investments

## Finance revenue

Finance revenue was \$262,184 in FY 2009 compared to \$56,201 in FY 2008. The Fraser Paper contract in Thurso, Quebec was delivered through the THERMAL-AUD program and was accounted for as a sales-type lease and accordingly, a portion of the payments received under the lease agreement were recognized as finance revenue.

## Net Loss

Net Loss was \$3,205,377 in FY 2009 compared to a net loss of \$2,372,508 in FY 2008. Together with the changes summarized above, insufficient sales volume to cover the current level of fixed costs in the Company to produce a net profit continued.

Management continues to work hard to control overhead costs but its main focus at the present time is to leverage the sales of its proprietary technologies worldwide in a cost effective manner by continuing to develop a number of strategic alliances, cooperative partnerships, and synergistic sales agencies and agreements with companies in all of its key markets.

## Liquidity

The working capital of \$3,791,332 at the end of FY 2009 increased significantly compared to the working capital deficiency of \$2,093,061 at the end of FY 2008. Current assets increased by \$4,144,553 to \$5,824,562. The substantial improvement in working capital was the result of the private placement in June, 2008. Cash and short-term investments increased by \$2,728,022, accounts receivable by \$777,353, inventories by \$554,577, the current portion of the net investment in lease by \$105,545 and prepaids and other assets by \$135,036 while contracts in progress decreased by \$156,000. Current liabilities decreased by \$1,739,860 to \$2,033,230. The changes were the result of decreases in the bank loan of \$239,580, accounts payable of \$1,438,592 and deferred revenue of \$363,916, offset by an increase in accrued liabilities of \$302,228.

Management continues to recognize the requirement to maintain liquidity in order to continue as a going concern, and as a result is aggressively working to increase sales and is continuing to develop new cooperative business relationships and exclusive sales distributorships in different, but complementary, product lines

Management's discussions which began in the fourth quarter of FY 2008 to structure a multi-million dollar financing of its new Business Plan involving the acquisition of GEM Ltd., of Bristol, U.K., culminated with the successful completion of a brokered private placement with gross proceeds of \$15,000,000 in the first quarter of fiscal year 2009. The proceeds raised were used for completing the acquisition of GEM, to expand sales and marketing efforts in North America, Europe and China.

## Related Party Transactions

In FY 2009 Directors were paid fees for services of \$113,000 and Officers were paid \$132,000. The Chairman of the Board of Directors was paid an annual fee of \$18,000. Additionally, one other Director was paid \$50,000 for consulting services pertaining to the financing of the GEM acquisition.

800,000 common shares were issued to Directors in 2009.

Options outstanding for Directors as at May 31, 2009 were 3,500,000 of which 2,961,000 were exercisable. There were 37,500 warrants outstanding for Directors.

Loans including accrued interest to enable the exercise of options and purchase shares in the amount of \$381,139 for Directors, \$184,960 for Officers and \$321,971 for other shareholders were outstanding at May 31, 2009.

The shares acquired by exercising options will be held by the Company until the loans are repaid.

## Management Compensation Disclosure

Compensation paid to directors and officers was as follows:

	Salaries and fees		Commissions		Total	
	2009	2008	2009	2008	2009	2008
	\$	\$	\$	\$	\$	\$
<b>Directors</b>						
T. Angus	174,000	169,400	-	19,278	174,000	188,678
J. Parker	25,500	25,500	-	-	25,500	25,500
M. Williams	7,500	7,500	-	-	7,500	7,500
C. Sharples	7,500	7,500	-	-	7,500	7,500
J. Ansell	7,500	7,500	-	-	7,500	7,500
J. Kelly	7,500	7,500	-	-	7,500	7,500
W. Crossland	57,500	58,125	-	-	57,500	58,125
M. Lloyd	-	3,125	-	-	-	3,125
<b>Total</b>	<b>287,000</b>	<b>286,150</b>	<b>-</b>	<b>19,278</b>	<b>287,000</b>	<b>305,428</b>
<b>Officers</b>						
O. Toffoli	132,000	107,000	4,219	29,436	136,219	136,436

D. Forget	-	64,000	-	31,408	-	95,408
A. Pugliese	<b>96,750</b>	84,286	-	22,571	<b>96,750</b>	106,857
A. Pugliese - severance	<b>75,250</b>	-	-	-	<b>75,250</b>	-
G. Piiva	<b>43,350</b>	57,800	-	-	<b>43,350</b>	57,800
G. Piiva - severance	<b>17,500</b>	-	-	-	<b>17,500</b>	-
Total	<b>364,850</b>	313,086	<b>4,219</b>	83,415	<b>369,069</b>	396,501

## Segmented Information

In fiscal 2009 and 2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America and Europe (only North America in 2008) and was also engaged in the start-up phase of similar operations in China. Within this business segment, the Corporation markets, sells, engineers, fabricates, constructs, installs and supports three retrofit technology lines – waste energy recovery solutions, air emission control solutions and condensate return system solutions. Assets are located in Canada and Europe.

The Company operated in three reportable segments in fiscal 2009 (two in 2008). In the waste energy recovery and air emission control business, customers finance these projects entirely from their own resources or through the Company's Thermal-AUD™ system whereby the Company finances the project and leases back the facility to the customer. This gives rise to two reportable segments. The third segment is in the condensate return system solutions business through its acquisition of Gardner Energy Management Limited (GEM™) on July 1, 2008. These three reportable segments are detailed below:

	Customer financed contracts & other		Thermal-AUD™ contract		GEM™	
	2009	2008	2009	2008	2009	2008
	\$	\$	\$	\$	\$	\$
Revenue from external customers	<b>725,603</b>	2,716,366	-	2,209,842	<b>3,233,319</b>	-
Inter-segment revenues	<b>127,068</b>	19,111	-	-	<b>96,206</b>	-
Interest and finance revenue	<b>82,823</b>	32,098	<b>262,184</b>	56,201	<b>345</b>	-
Interest and bank charges	<b>7,623</b>	13,503	<b>30,870</b>	6,914	<b>66,573</b>	-
Amortization of property, plant and equipment	<b>29,754</b>	31,314	-	-	<b>21,466</b>	-
Amortization of intangibles	-	-	-	-	<b>149,691</b>	-
Segment loss (profit)	<b>2,985,492</b>	2,391,014	<b>(100,978)</b>	(18,506)	<b>400,619</b>	-
Expenditures for property, plant and equipment	<b>25,318</b>	28,768	-	-	<b>13,773</b>	-
Expenditures for intangible assets	-	-	-	-	<b>1,679,000</b>	-
Expenditures for goodwill	-	-	-	-	<b>3,449,799</b>	-
Total assets	<b>6,450,829</b>	2,755,526	<b>2,064,620</b>	2,225,562	<b>6,370,073</b>	-

	2009	2008
Reconciliation to financial statements	\$	\$
Revenues		
Total revenues for reporting segments	<b>4,182,196</b>	4,945,319
Elimination of inter-segment revenues	<b>(223,274)</b>	(19,111)
Total company revenues	<b>3,958,922</b>	4,926,208
Loss		
Total loss for reported segments	<b>3,205,377</b>	2,572,508

Income tax recovery	-	(200,000)
Net loss	<b>3,205,377</b>	2,372,508
Assets		
Total assets for reported segments	<b>14,885,522</b>	4,981,088
Elimination of inter-segment receivables	<b>(1,727,911)</b>	(1,287,087)
Elimination of other inter-segment assets	<b>(607,181)</b>	-
Total assets	<b>12,550,430</b>	3,694,001

Other significant items	2009			2008		
	Segment totals	Adjustments	Company totals	Segment totals	Adjustments	Company totals
	\$	\$	\$	\$	\$	\$
Interest and finance revenue	<b>345,352</b>	<b>(5,277)</b>	<b>340,075</b>	88,299	-	88,299
Interest and bank charges	<b>105,066</b>	<b>(5,277)</b>	<b>99,789</b>	20,417	-	20,417
Amortization of property, plant and equipment	<b>51,220</b>	-	<b>51,220</b>	31,314	-	31,314
Amortization of intangible assets	<b>170,958</b>	-	<b>170,958</b>	-	-	-
Expenditures for property, plant and equipment	<b>39,091</b>	-	<b>39,091</b>	28,768	-	28,768
Expenditures for intangible assets	<b>1,679,000</b>	-	<b>1,679,000</b>	-	-	-
Expenditures for goodwill	<b>3,449,799</b>	-	<b>3,449,799</b>	-	-	-

### Geographic Segments

	Revenues		Property, plant & equip		Goodwill & intangibles		Sales-type lease	
	2009	2008	2009	2008	2009	2008	2009	2008
	\$	\$	\$	\$	\$	\$	\$	\$
Canada	<b>53,028</b>	2,382,444	<b>60,630</b>	65,066	-	-	<b>2,002,864</b>	2,175,940
United States	<b>749,575</b>	2,507,137	-	-	-	-	-	-
Europe	<b>3,077,302</b>	-	<b>37,112</b>	-	<b>4,957,841</b>	-	-	-
China	<b>79,017</b>	36,627	-	-	-	-	-	-
Total	<b>3,958,922</b>	4,926,208	<b>97,742</b>	65,066	<b>4,979,108</b>	-	<b>2,002,864</b>	2,175,940

Revenues from outside customers are attributed to the geographic segments based on the location of the project.

## Supplementary Financial Information

The following table shows selected consolidated financial data for the three most recently completed financial years.

Financial information for the years ending May 31, 2007, May 31, 2008 and May 31, 2009

	2007 \$	2008 \$	2009 \$
Sales	821,024	4,926,208	3,958,922
Net loss	(2,443,265)	(2,372,508)	(3,205,377)

Net loss per share – basic and diluted	(0.031)	(0.025)	(0.020)
Total assets	2,131,163,	3,694,001	12,550,430

The earned revenue from sales in FY 2007, FY 2008 and FY 2009 are inconsistent in magnitude. In FY 2007, while secured sales orders increased to approximately \$3.9 million year-over-year, because of long delays in the awarding of two contracts, the revenue recognized nonetheless fell significantly.

The net losses in FY 2007 were due to a significant drop in earned revenue from sales as a result of a three to four month delay encountered in signing its first two U.S. contracts.

While the net losses decreased slightly in FY 2008 compared to FY 2007, they remained consistent in magnitude due to cost over-runs and foreign exchange losses at the Phillips project in the amount of \$380,163 and warranty related costs of \$122,793 at Valley Regional Hospital, Minas Basin and Camco. Increased administration, selling, marketing and business development costs of \$396,500, increased legal and insurance costs of \$313,000 and \$49,500 respectively all contributed to the loss.

The net losses increased in FY 2009 due to a decrease in carry-over volume of work from FY 2008, a decrease in new sales revenue, increases due to the hiring of 4 new sales personnel of \$335,000, severance costs resulting from terminations of \$99,950, additional GEM costs of approximately \$1,557,000.

The variations in assets from FY 2007 through to FY 2009 were affected primarily by the closing of five private placements in the amount of \$2,747,138 in FY 2007. The increase in assets for FY 2008 was primarily due to the accounting treatment of the Fraser Paper contract as a sales-type lease. The increase in asset in FY 2009 was due to the closing of a brokered private placement in the amount of \$15,000,000.

#### Disclaimer

The information provided in this document is not intended to be a comprehensive review of all matters concerning the Company. It should be read in conjunction with all other disclosure documents provided. No securities commission or regulatory authority has reviewed the accuracy or adequacy of the information presented herein and, as noted in the financial statements ended May 31, 2009, these statements were subject to an audit by our independent public accountants.

## Business Risks

Management is confident about our long-term prospects, but we recognize that we are exposed to a number of risks in the normal course of business that could negatively impact the financial condition of the Company.

The Company is engaged in the development, engineering and supply of pollution control and heat recovery systems. Operational risks of the company include the ability to continue to secure and implement multiple sales contracts each year for its FLU-ACE® technology solutions. In addition, the Company had not yet been able to complete the development and commercialization of its patented THERMALONOX™ technology at year end. The Cost Effective Energy Conservation and Environmental Compliance Solutions sales through the close working relationship with JCI and Honeywell China has not limited the size of the market but has increased the market potential.

Financial risks and uncertainties of the Corporation include:

- The Company's history of operating losses and uncertainty of future profitability;
- The ability to continue to grow quicker sales through its working relationship with JCI;
- The ability to grow sales through the establishment of new cooperative partnerships and strategic alliances;

- The ability to grow sales through the licensing of the corporation's technologies;
- The ability to secure and maintain the required outside working capital financing;
- The ability to achieve profitable operations through increased sales,
- Reliance on third party collaborations and license arrangements;
- Reliance on proprietary technology;
- Competition in the energy conservation and environmental compliance solutions;
- Product liability claims and insurance;
- Reliance on key personnel;
- The ongoing litigation with its former President & CEO;
- The ability to control costs and achieve a positive gross margin on projects; and,
- The effect of a prolonged recession in Canada, USA and Europe to the financial markets in securing project financing and in particular to industrial and commercial customers in committing capital to projects.
- The effect of a temporary or permanent plant shutdown at Fraser Paper Inc.'s Thurso plant.

## Management's addressing of the risks

The management of the Company realizes that the operating losses in FY 2009, display a consistent pattern of losses as in previous years. However with the previous fiscal year's losses partly attributed to new management transition costs and to remedial costs on past projects, the Company is now fully focused on sales and marketing and is expanding its drive towards that purpose with the addition of a number of new sales staff, sales agents, strategic alliances and cooperative partnerships to promote the Company's solutions in the United States, Canada, Europe and China.

The costs in FY 2009 associated with administration and sales, marketing and business development were necessary to advance the sales cycle forward which will become evident in future quarters.

Management believes that it can leverage off of its wholly-owned subsidiary's (ForEverGreen Energy Inc.) successful signing of an agreement of up to \$3.75M with Fraser Paper Inc. to recover waste heat using the THERMAL-AUD™ program and use the same process in other mills.

Management is presently in late discussions with several large companies that it believes will result in the signing of new cooperative partnership agreements that could help to grow its sales and possibly lead to licensing agreements after successful trials of the Company's technologies.

Management is also increasing focus on key institutional markets which are anticipated to receive significant investment from the federal governments both in the US and Canada. This includes a focus on hospitals, universities and government facilities. In line with the strategy, the Company is focused on leveraging the current relationship with JCI and building new relationships with other Energy Service Companies which are expected to benefit greatly in the US by the new administration's spending plans and loan guarantees to increase energy efficiency of institutional facilities.

Management has demonstrated that it can secure outside working capital as evidenced by the successful closings of its private placement with gross proceeds of \$778,639, in Q3 FY 2007, with gross proceeds of \$1,968,500 in Q4 FY 2007 and with gross proceeds of \$1,017,750 in Q3 FY 2008. In addition, during this period, it has realized \$200,000 through the closing of smaller private placements and the exercise of options and warrants. Finally, in Q1 FY 2009, management closed an oversubscribed brokered private placement of common shares with gross proceeds of \$15,000,000.

Management believes that by maintaining its small core of personnel, reducing non-essential employee costs and miscellaneous overhead and higher margins on more secured contracts, it will achieve profitable operations. Small incremental staffing increases will be introduced from time to time as evidenced in FY 2009 depending on the demand arising from increased sales volumes, however management has also been aggressively implementing measures to reduce total SG&A costs as evidenced by the reduction of five (5) employees in Q3 and Q4 FY 2009 due to deteriorating economic conditions.

Management has acquired GEM®, a leading European (Great Britain) line of industrial/commercial steam traps; and DRY-REX™, a technology that uses waste heat to turn bark, sludge and other biomass into high-efficiency bio-energy fuel for the pulp & paper and other industrial applications. In connection with these technologies, the Company has received multiple purchase orders from Dow Corning in Kentucky, Hemlock Semiconductor Corporation in Michigan, Anheuser-Busch, Inc. in Colorado, GlaskoSmithKline in North Carolina, Greenfield Ethanol in Chatham, Ontario, Alberta Envirofuels Inc., Rogers Sugar in B.C., CFB Kingston, CFB Trenton, Fraser Papers at Thurso, Catalyst Paper in B.C., Lee & Man Paper Manufacturing Co. and Jiangsu Huachang Chemical Co., Coca Cola, BASF, all located in China, and has conducted audits for its implementation at other industrial sites and awaits new trial orders.

The Company is protecting its proprietary technology through registered trademarks and confidentiality agreements. It has recently filed a new provisional patent for THERMALONOX™, a technology which is currently undergoing laboratory testing.

The Company maintains adequate forms of general liability insurance including product liability and errors and omission coverage.

Management believes that competition against its core technology of FLU-ACE™ and DRY-REX® is limited at this time and believes that the market place is sufficiently large enough to permit stronger competition in the future. Management also believes that while there is greater competition to its newly acquired GEM® product line, that the Company is well positioned to penetrate the market with a far superior product. It is the opinion of management that the Company is in a better position now with a significantly enhanced arsenal of building blocks to draw on in presenting a more comprehensive solution to customers.

The Company is adequately protected in its contract with Fraser Paper Inc. for payments arising from a temporary shutdown of the mill on an established per diem rate. If the temporary shutdown becomes a permanent shutdown, Fraser Paper is obligated to pay a lump sum payment and the Company is required to remove the equipment within six months of such notification. However, the Company has no control or ability to recoup any receivables in the event of a declared bankruptcy by Fraser Papers Inc.

## Highlights

On June 23, 2008, the Corporation announced that it had closed an oversubscribed brokered private placement of common shares with gross proceeds of \$15,000,000. The placement was subscribed by a number of the most recognized renewable energy and sustainability focused funds in Toronto, New York and London (U.K.). The funds raised were to complete the acquisition of Gardner Energy Management Ltd. in the U.K. (requiring approximately CAD\$5.4 M) and to provide the Corporation a funding base for future investment in its product line of assets under THERMAL-AUD™ green energy supply contracts. The financing which was handled by agents Max Capital Markets Ltd. and Jacob and Company Securities Inc. (both headquartered in Toronto) consisted of an issuance of 68,181,818 common shares of the Corporation at a price of \$0.22 per share.

On July 2, 2008, the Corporation announced that it had completed the acquisition of Gardner Energy Management Ltd. ("GEM") of Bristol, U.K. Under the terms of the transaction, the Corporation made a base payment of 2.7 M British Pounds Sterling (or CAD \$5.4M) upon closing on July 1, 2008. An additional payment of up to 1.3 M British Pounds Sterling (or CAD \$2.6M) may be made on an earn-out basis in a combination of cash and shares over a three-year period subject to defined future growth targets of the GEM® business unit.

On September 22, 2008, the Corporation announced the launch of a new "quick fit"

line of Emerald traps for its GEM® Condensate Return System. The Emerald GEM® Trap is compatible with other manufacturers' fittings, which allows them to be easily bolted on to existing connectors. These "quick fit" traps as well as the entire series of GEM® Traps were showcased at the Oil Sands Trade Show in Edmonton, Alberta between September 23 and 24, 2008.

On November 6, 2008, the Corporation announced the appointment of numerous sales, marketing and business development staff in Canada, United States and Europe.

On November 20, 2008, the Corporation announced that it had shipped equipment to China for demonstration-scale testing of its THERMALONOX™ process for reducing nitrogen oxides (NOx) for power plants. The equipment is to be installed at Guangzhou Yuanchun Cogeneration Co., Ltd., a 50 MW power plant in Guangdong province, China, under the joint venture research and development program with the South China University of Technology.

On December 1, 2008, the Corporation announced that the resolutions presented in the Management Information Circular of October 16, 2008 were approved by shareholders at Annual and Special Meeting held on November 25, 2008. The Corporation also gave an update to a press release made on June 3, 2008 by stating that the proposed project had been scaled back due to a number of changes at the client's site resulting in a reduction of approximately 50% to the proposed project still under negotiations.

On February 16, 2009, the Corporation announced that the project initially referred to in a press release made on June 3, 2008, followed with an update in the press release made on December 1, 2008, has been removed from the sales pipeline and forecast and that the Corporation no longer anticipates the project proceeding in the foreseeable future. The reasons given by the customer was related to capital appropriation and availability challenges under the current economic conditions.

On April 17, 2009, the Corporation announced the departure of Anthony Pugliese, Vice President of Sales.

## Outlook

Statements in this discussion are forward-looking and as such, are subject to various risks and uncertainties concerning a variety of factors. Such information contained herein represents management's best judgment as of the date hereof based on the information currently available.

During Q1 of FY 2010, the Corporation has been focused equally on direct sales and cooperative sales development activities in Canada, USA, Europe and China. The majority of the Corporations' sales, marketing, and business development resources have been utilized in support of some direct sales development activities through independent sales agents in Michigan, Maine, Ontario, Quebec, British Columbia, Alberta, Mexico and China to selected industrial process facilities where existing customer relationships are already in place and to a lesser extent in support of the Johnson Controls' cooperative energy solutions sales development activities.

The Corporation anticipates that these initiatives will produce increased sales revenues and gross profit and become a harbinger for continued improvement to the Consolidated Balance Sheet.

On June 8, 2009, the Corporation announced that it had concluded an agreement with Kemco Systems Inc. (Kemco) of Clearwater, Florida to become the exclusive distributor of Kemco products in all areas globally except North and South America. Kemco is a recognized leader in providing high efficiency, environmentally friendly water heaters, heat recovery and water treatment systems that will save water, labour, energy, sewer and chemical costs.

On June 9, 2009, the Corporation announced that it had secured several important orders for the GEM business in the Middle East and China. One order in excess of CAD\$450,000 was from the Kuwait National Petroleum Corp at its Mina Al-Ahmed refinery located in Kuwait. The other two orders in excess of CAD\$200,000 from an European based global pharmaceutical corporation for its plants in North East China.

On July 22, 2009, the Corporation announced that it had received an order of 215,000 British Pound Sterling (approximately CAD\$393,000) from a hospital located in Belfast, Northern Ireland to install a condensing heat recovery system. This is the first contract secured under the Corporation's new exclusive distribution agreement for the Kemco product lines.

On August 7, 2009, the Corporation announced that Tim Angus resigned as President and CEO and as Director from the Corporation's board for personal reasons and William Crossland was appointed President and CEO.

On August 21, 2009, the Corporation announced that Clint Sharples resigned from the Board of Directors, effective August 20, 2009 in order to pursue other business opportunities.

On September 15, 2009, the Corporation announced Board of Director and Officer changes. John R. Parker resigned as Chairman of the Board and Director of the Corporation. John Kelly was appointed as Chairman of the Board. Oliver Toffoli resigned as Chief Financial Officer of the Corporation but is to remain with the company in the areas of operations and project management. Michael Williams assumed the role of Chief Financial Officer on an interim basis until such time as a permanent replacement can be appointed.

# MANAGEMENT RESPONSIBILITY STATEMENT

The consolidated financial statements of Thermal Energy International Inc. and all the information in this annual financial report have been prepared by management, which is solely responsible for the integrity and fairness of the data presented, including the many amounts, which due to necessity, are based on estimates and judgments. The accounting policies followed in the preparation of these consolidated financial statements conform to Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those that it deems most appropriate in the circumstances. Financial information presented throughout this report is consistent with that in the consolidated financial statements.

Thermal Energy International Inc. maintains systems of internal accounting and administrative controls to provide reasonable assurance that the financial information is relevant, reliable and accurate and that transactions are authorized, assets are safeguarded and proper records are maintained.

The Board of Directors is responsible for ensuring that management fulfills its responsibility principally through its Audit Committee.

Thermal Energy International Inc.'s external auditors, Raymond Chabot Grant Thornton LLP ("RCGT"), have conducted an independent audit of the consolidated financial statements in accordance with Canadian generally accepted auditing standards, performing such tests and other procedures as they consider necessary to express an audit opinion. The external auditors have full and unrestricted access to the Audit Committee to discuss their audit and related findings.



William Crossland  
President & CEO



Michael Williams  
CFO

# AUDITORS' REPORT



Raymond Chabot Grant Thornton LLP  
2505 St-Laurent Blvd.  
Ottawa, Ontario K1H 1E4  
Telephone: 613-236-2211  
Fax: 613-236-6104

[www.rcgt.com](http://www.rcgt.com)

To the shareholders of Thermal Energy International Inc.

We have audited the consolidated balance sheets of Thermal Energy International Inc. as at May 31, 2009 and 2008 and the consolidated statements of operations and comprehensive loss, deficit and contributed surplus, accumulated other comprehensive loss and of 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, 2009 and 2008 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,

Licensed Public Accountants

Ottawa, Canada

September 28, 2009

# FINANCIAL STATEMENTS

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

## CONSOLIDATED BALANCE SHEETS

As at May 31

	2009	2008
	\$	\$
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents (note 6)	3,365,512	637,490
Accounts receivable (note 7)	1,404,924	627,571
Contracts in progress	-	156,000
Inventories (note 8)	554,577	-
Net investment in lease (note 11)	332,579	227,034
Prepays and other assets	166,970	31,934
	<b>5,824,562</b>	<b>1,680,029</b>
Property, plant and equipment (note 9)	97,742	65,066
Net investment in lease (note 11)	1,670,285	1,948,906
Intangible assets (notes 5 and 10)	1,508,042	-
Goodwill (note 5)	3,449,799	-
	<b>12,550,430</b>	<b>3,694,001</b>
<b>LIABILITIES</b>		
<b>Current liabilities</b>		
Bank loans (note 13)	669,087	908,667
Accounts payable	581,146	2,019,738
Accrued liabilities	762,005	459,777
Deferred revenue	20,992	384,908
	<b>2,033,230</b>	<b>3,773,090</b>
Non-controlling interest (note 5)	(6,609)	-
<b>SHAREHOLDERS' EQUITY</b>		
Capital stock (note 15)	32,547,779	19,479,079
Contributed surplus	2,284,713	1,528,414
Deficit	(24,231,240)	(21,086,582)
Accumulated other comprehensive loss	(77,443)	-
	<b>10,523,809</b>	<b>(79,089)</b>
	<b>12,550,430</b>	<b>3,694,001</b>

Contingency (note 25)

The accompanying notes are an integral part of these consolidated financial statements On behalf of the Board



President & CEO



CFO

## CONSOLIDATED OPERATIONS AND COMPREHENSIVE LOSS

Years ended May 31

	2009	2008
	\$	\$
<b>REVENUE</b>		
Sales	3,958,922	4,926,208
Cost of sales	1,595,293	4,318,184
<b>Gross profit</b>	<b>2,363,629</b>	<b>608,024</b>
Expenses		
Administration	2,033,475	1,228,984
Selling, marketing and business development	3,036,714	1,314,208
Legal fees	90,459	331,836
Audit fees	55,794	72,839
Insurance	119,274	127,993
Amortization of property, plant and equipment	51,220	31,314
Amortization of intangible assets	170,958	-
Patent and trademark maintenance	18,151	13,587
Research and development	204,880	87,572
Interest and bank charges	99,789	20,417
Foreign exchange loss	21,693	40,081
	<b>5,902,407</b>	<b>3,268,831</b>
Loss before the following:	<b>(3,538,778)</b>	<b>(2,660,807)</b>
Interest revenue	77,891	32,098
Finance revenue	262,184	56,201
Loss before income taxes and non-controlling interest	<b>(3,198,703)</b>	<b>(2,572,508)</b>
Future income tax recovery (note 17)	-	200,000
<b>Loss before non-controlling interest</b>	<b>(3,198,703)</b>	<b>(2,372,508)</b>
Non-controlling interest	(6,674)	-
<b>Net loss</b>	<b>(3,205,377)</b>	<b>(2,372,508)</b>
Unrealized losses on translating financial statements of self-sustaining foreign operations (net of taxes)	(77,443)	-
<b>Comprehensive loss</b>	<b>(3,282,820)</b>	<b>(2,372,508)</b>
Net loss per share - basic and diluted	(0.020)	(0.025)
Weighted average number of common shares	163,351,609	94,665,536

The accompanying notes are an integral part of these consolidated financial statements and Note 18 provides other information on earnings

## CONSOLIDATED DEFICIT AND CONTRIBUTED SURPLUS

Years ended May 31	2009	2008
	\$	\$
<b>Deficit</b>		
Balance, beginning of year	(21,086,582)	(18,714,074)
Interest on loans to acquire common shares (net of tax)	60,719	
Net loss	(3,205,377)	(2,372,508)
Balance, end of year	(24,231,240)	(21,086,582)
<b>Contributed Surplus</b>		
Balance, beginning of year	1,528,414	1,881,487
Stock-based compensation	189,099	495,786
Issuance of warrants (note 15)	636,200	-
	2,353,713	2,377,273
Fair-value of stock options exercised and transferred to capital stock	69,000	848,859
Balance, end of year	2,284,713	1,528,414

## CONSOLIDATED ACCUMULATED OTHER COMPREHENSIVE LOSS

Years ended May 31	2009	2008
	\$	\$
Balance, beginning of year	-	-
Unrealized losses on translating financial statements of self-sustaining foreign operations	(77,443)	-
Balance, end of year	(77,443)	-

The accompanying notes are an integral part of these consolidated financial statements and Note 18 provides other information on earnings.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended May 31

	2009	2008
	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net loss	(3,205,377)	(2,372,508)
Add items not involving cash:		
Stock-based compensation charge	189,099	495,786
Amortization of property, plant and equipment	51,220	31,314
Amortization of intangible assets	170,958	-
Future income taxes (note 17)	-	(200,000)
Non-monetary compensation charge	-	152,171
Non-controlling interest	6,674	-
Changes in non-cash operating working capital		
Accounts receivable	22,133	(198,990)
Contracts in progress	156,000	(152,000)
Inventories	(17,871)	-
Prepays and other assets	(83,436)	28,960
Accounts payable	(1,693,868)	1,673,619
Accrued liabilities	(256,022)	301,695
Deferred revenue	(363,184)	(615,092)
Net cash used in operating activities	(5,023,674)	(855,045)
<b>INVESTING ACTIVITIES</b>		
Acquisition of subsidiary, net of cash acquired	(5,350,526)	-
Additions to property, plant and equipment	(39,091)	(28,768)
Net cash used in investing activities	(5,389,617)	(28,768)
<b>FINANCING ACTIVITIES</b>		
Increase (decrease) in bank loan	(647,377)	908,667
Investment in lease (note 11)	-	(2,209,842)
Lease payments received	173,076	33,902
Common shares issued (note 15)	14,885,400	1,218,500
Share issue costs	(1,267,000)	-
Net cash provided by (used in) financing activities	13,144,099	(48,773)
Effect of exchange rate fluctuations on cash and cash equivalents	(2,786)	-
Increase (decrease) in cash and cash equivalents for the year	2,728,022	(932,586)
Cash and cash equivalents, beginning of year	637,490	1,570,076
Cash and cash equivalents, end of year	3,365,512	637,490
Interest paid	42,915	5,444
Tax impact of renounced expenditures	-	200,000

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

# NOTES TO 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, heat recovery systems, and condensate return solutions.

## 2 GOING CONCERN

The Company incurred losses from operations in the years ended May 31, 2009 and 2008 and has significant accumulated deficits as at those dates.

There is significant doubt about the Company's ability to continue as a going concern. The Company's ability to realize its assets and discharge its liabilities depends on 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.

## 3 BASIS OF PRESENTATION AND ACCOUNTING CHANGES

The accompanying consolidated financial statements of Thermal Energy International Inc. have been prepared by management in accordance with Canadian generally accepted accounting principles.

The Canadian Institute of Chartered Accountants ("CICA") issued the following new Handbook sections, which became effective for the Company on or after June 1, 2008.

### Going concern

Section 1400 - General Standards of Financial Statement Presentation - which requires management to make an assessment of the Company's ability to continue as a going concern. When financial statements are not prepared on a going concern basis, that fact shall be disclosed together with the basis on which the consolidated financial statements are prepared and the reason why the company is not considered a going concern. The Company adopted this policy with no significant effect on these consolidated financial statements.

### Capital disclosures

Section 1535 - Capital Disclosures specifies the disclosure of: (i) an entity's objectives, policies and procedures for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and (iv) if it has not complied, the consequences of such non-compliance. As a result of the adoption of this standard, additional disclosure on the Company's capital management strategy have been included in Note 21.

### Financial instruments – disclosures

Sections 3862 - Financial Instruments – Disclosures and 3863 - Financial Instruments – Presentation - replace Handbook Section 3861, Financial Instruments – Disclosures and Presentation, revising its disclosure requirements, and carrying forward its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. Section 3862 specifies disclosures

that enable users to evaluate: (i) the significance of financial instruments for the entity's financial position and performance; and (ii) the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. As a result of the adoption of these standards, additional disclosures on the risks of certain financial instruments have been included in Note 22.

### Inventories

Section 3031 - Inventories - replacing Section 3030 - Inventories. The Section prescribes the accounting treatment for inventories such as measurement of inventories at the lower of cost and net realizable value. It provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-downs to net realizable value and reversal of previous write-downs of inventories arising from an increase in net realizable value. It also provides guidance on the cost methodologies that are used to assign costs to inventories and it describes the required disclosures on the carrying amount of inventories, the amount of inventories recognized as an expense and the amount of write-downs or reversal of write-downs of inventories. The Company adopted this policy with no significant effect on these consolidated financial statements.

### Credit risk and the fair value of financial assets and financial liabilities

On January 20, 2009, the Emerging Issues Committee of the CICA approved abstract No. 173 "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities" (EIC-173), which clarifies that an entity's own credit risk and the credit risk of its counterparty should be taken into account in determining the fair value of financial assets and liabilities. EIC 173 is to be applied retrospectively without restatement of prior periods to all financial assets and liabilities measured at fair value in interim and annual financial statements for periods ending on or after the date of issuance of this abstract. The Company adopted this policy with no significant effect on these 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 subsidiaries, ForEverGreen Energy Inc., 2003356 Ontario Inc., 2153639 Ontario Inc., Gardner Energy Management Limited ("GEM") and Thermal Energy International Corporation. All of these entities are incorporated under the Ontario Business Corporations Act, except for GEM, which is incorporated under the laws of the United Kingdom and Thermal Energy International Corporation incorporated under the laws of the State of Delaware in the United States of America. The Company has a jointly controlled entity, Thermal Energy International (Guangzhou) Ltd, which it records on a proportionate share.

GEM has two consolidated subsidiaries, one of which has a minority interest.

### 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. The most significant estimates include, but are not limited to: assumptions used in the determination of intangible assets and goodwill and any related impairment, future production outputs related to the net investment in lease, percentage of completion for contracts, assumptions used in the Black-Scholes fair value calculations and valuation allowances against future tax assets. 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 recognized when total cost estimates indicate a loss. Amounts billed or payments received but not yet earned are deferred until the revenue is earned.

Revenue from product sales is recognized when there is persuasive evidence that an arrangement exists; products are shipped; the selling price is fixed or determinable and collection is reasonably assured. Amounts received in advance of meeting the revenue recognition criteria is recorded as deferred revenue on the consolidated balance sheet.

The Company guarantees its condensate return solution product against defects for ten years and does not offer extended warranties. An allowance for warranty expense is recorded when the revenue for the related product is recognized. The allowance is based upon the terms of the warranty, the Company's historical experience and management estimates of future expense for replacement or repairs. The allowance is recorded in cost of goods sold.

#### Financial assets and liabilities measurement basis

On initial recognition, all financial assets and liabilities are measured and recognized at their fair value, except for financial assets and liabilities resulting from certain related party transactions. Transaction costs from held-for-trading financial assets are recognized in earnings. Transaction costs from other financial liabilities reduce the carrying amount of the related financial liabilities. Subsequently, financial assets and liabilities are measured and recognized as follows:

##### Initial measurement

On initial recognition, all financial assets and liabilities are measured and recorded at fair value.

##### Subsequent measurement

Subsequent to initial recognition, the financial assets and liabilities are measured as follows:

##### Held-for-trading financial assets

Cash and cash equivalents are classified as held-for-trading assets. Held-for-trading financial assets are measured at their fair value and related unrealized gains or losses are recognized in the consolidated statement of operations.

##### Loans and receivables

Trade accounts receivable and other accounts receivable are classified as loans and receivables. Trade accounts receivable are measured at amortized cost, which is generally the initially recognized amount, less any allowance for doubtful accounts. An allowance for trade accounts receivable is made when the Company has obtained an objective indication that it will not be able to collect the amount due according to the original terms and conditions agreed to with customers. Indications that trade accounts are impaired include customers experiencing significant financial difficulties, the increasing possibility of a customer going bankrupt or undergoing a financial restructuring and payment default or delays. Other accounts receivable, including amounts due from related party, are recognized at amortized cost using the effective interest method, less any impairment.

##### Other financial liabilities

The bank loan, accounts payable, accrued liabilities and amounts due to past President are classified as other financial liabilities. They are measured initially at fair value. Subsequent measurements are recognized at amortized cost using the effective interest method.

#### Cash and cash equivalents

All highly liquid investments with original maturities of three months or less are classified as cash equivalents.

#### Inventories

Inventories are valued at the lower of cost and net realizable value after making due allowance for obsolete and slow-moving items. Cost includes all direct costs and an appropriate proportion of fixed and variable overheads where applicable.

#### Amortization

Property, plant and equipment are recorded at cost. Amortization is computed using the following annual rates and methods which reflect the estimated useful life of the assets:

Plant and equipment	25% declining balance
Furniture and fixtures	20% declining-balance
Laboratory equipment	20% declining balance
Computers	3 years straight-line
Software	50% declining-balance
Leasehold improvements	3 years straight-line

Intangible assets were acquired at the fair market value with the acquisition of Gardner Energy Management on July 1, 2008. Amortization is computed using the following rates and methods which reflect the estimated useful life of the assets:

Trade names and trademarks	indefinite life
Non-compete agreements	2 years straight-line
Industrial know-how	5 years straight-line
Designs and drawings	5 years straight-line
Customer relationships	5 years straight-line

#### Impairment of long-lived assets

Tangible and intangible assets subject to amortization are tested for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. The carrying amount of these assets is not recoverable when it exceeds the sum of the undiscounted cash flows expected from its use and eventual disposal. Intangible assets which are considered to have indefinite lives are tested for impairment annually. The carrying amount of these assets is not recoverable when it exceeds the sum of the discounted cash flows expected from its use and eventual disposal. In such cases, an impairment loss must be recognized and is equivalent to the excess of the carrying amount of a long-lived asset over its fair value.

#### Goodwill

Goodwill is the excess of the cost of an acquired enterprise over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is not amortized. It is tested for impairment annually or more frequently if events or changes in circumstances indicate that it is impaired. Potential goodwill impairment is identified by comparing the carrying amount of a reporting unit with its fair value. If any potential impairment is identified, it is quantified by comparing the carrying amount of goodwill to its fair value. The fair value of a reporting unit is calculated using discounted cash flows. On the basis of the impairment test as at May 31, 2009, the Company considers that a goodwill impairment expense is not required.

#### Comprehensive loss

Comprehensive loss is composed of the Company's net loss and other comprehensive loss. Other comprehensive loss includes foreign currency translation adjustments

of self-sustaining foreign operations, net of income taxes.

### 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. 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. In accordance with EIC Abstract 132 "Share Purchase Financing" common shares securing share purchase loans are considered to be contingently returnable for purposes of calculating diluted loss per share and are not treated as outstanding for purposes of calculating basic loss per share. The diluted loss per share is equal to the basic loss per share because the effect of dilutive stock options described in Note 15 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 principles for deferral and amortization. No costs have been deferred to date.

### Foreign currency translation of self-sustaining foreign operations

The financial statements of the Company's self-sustaining foreign subsidiary and joint venture are translated using the current rate method. Under this method, all assets and liabilities are translated at period-end rates and revenue and expenses at the average rate for the period. Resulting gains and losses are included in the statement of comprehensive loss for the period. When there is a reduction in the net investment of a self-sustaining foreign subsidiary, a proportionate amount of translation gains and losses is recognized in net loss.

### Foreign currency translation

All monetary assets and liabilities, other than for self-sustaining foreign operations, 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 statement of operations for the year.

### Accounting for equity units

Proceeds received on the issuance of units, consisting of common shares and warrants, are first allocated to common shares based on their fair value and the remainder is allocated to warrants.

### 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.

### Sales-type lease

Finance income related to the sales-type lease is recognized in a manner that produces a constant rate of return on the investment in the lease. The investment in the lease for purposes of income recognition is composed of estimated net minimum lease payments for the remainder of the lease term and unearned finance revenue.

### Pension benefit plans

The cost of the Company's pension benefits for defined contribution plans are expensed at the time active employees are compensated.

### 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.

Share purchase loans are accounted for in accordance with EIC Abstract 132 "Share Purchase Financing". These loans, which were extended to shareholders to purchase Class A common shares are considered to be stock options and are treated as stock-based compensation and recorded at their fair market value. The outstanding loan balance is deducted from capital stock and the accrued interest is recorded as a capital transaction in the statement of deficit.

### Share issue expenses

Share issue expenses are recorded as a reduction of share capital when the related shares are issued.

## 5 BUSINESS ACQUISITION

On July 1, 2008 the Company acquired all of the issued and outstanding shares of Gardner Energy Management Limited of Bristol, England, a company engaged in the condensate return solutions business, for a total cash consideration of \$5,411,245, including acquisition costs. An additional payment of up to £1,300,000 may be made in cash and shares over a three-year period based on Gardner Energy Management Limited meeting certain performance targets. In the year ended May 31, 2009 a provision of \$324,586 was made in the accounts towards this additional payment, which was recorded as goodwill and at May 31, 2009 brought the acquisition cost to \$5,735,831.

This transaction was accounted for using the purchase method and the results of operations are included in the consolidated financial statements from the acquisition date. The purchase price allocation is as follows:

	July 1, 2008	Additional Payment	May 31, 2009
	\$	\$	\$
Net assets acquired			
Current assets (including cash and cash equivalents of \$60,719)	1,717,481	-	1,717,481
Property, plant and equipment	50,202	-	50,202
Intangible assets (note 10)	1,679,000	-	1,679,000
Goodwill (75% of which is deductible for tax)	3,125,213	324,586	3,449,799
	6,571,896	324,586	6,903,949

Current liabilities assumed	(1,175,328)	-	(1,175,328)
Non-controlling interest	14,677	-	14,677
Net assets acquired	5,411,245	324,586	5,735,831

## 6 CASH AND CASH EQUIVALENTS

Cash equivalents consist of excess cash invested in money market funds

	2009	2008
	\$	\$
Cash	224,597	84,717
Money market funds	3,140,915	552,773
	3,365,512	637,490

## 7 ACCOUNTS RECEIVABLE

	2009	2008
	\$	\$
Trade	1,046,272	438,592
Commodity taxes	17,994	145,928
Directors and Officers	125,078	34,500
Related party	183,317	-
Other	32,263	8,551
	1,404,924	627,571

At May 31, 2009, 17% (2008 – 68%) of trade receivables were from one customer.

## 8 INVENTORIES

	2009	2008
	\$	\$
Work in process	554,577	-

Partly finished product is purchased from suppliers and held in inventory pending finishing to the customers requirements.

Inventory costs recorded as an expense for the year ended May 31, 2009 were \$396,351.

## 9 PROPERTY, PLANT AND EQUIPMENT

	2009		2008	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Plant and equipment	70,283	56,537		
Furniture and fixtures	108,623	95,147	81,671	66,330
Laboratory equipment	52,857	26,878	52,857	21,073
Computers	259,875	223,979	157,861	144,787
Software	33,213	24,568	16,971	14,525
Leasehold improvements	21,401	21,401	21,401	18,980

	546,252	448,510	330,761	265,695
Accumulated amortization	(448,510)		(265,695)	
<b>Net book value</b>	<b>97,742</b>		<b>65,066</b>	

## 10 INTANGIBLE ASSETS

	May 31, 2009	
	Cost	Accumulated Amortization
	\$	\$
Trade names and trademarks	928,000	-
Non compete agreement	121,000	55,458
Industrial know-how	141,000	25,850
Designs and drawings	156,000	28,600
Customer relationships	333,000	68,383
	1,679,000	170,958
Accumulated amortization	(170,958)	
<b>Net book value</b>	<b>1,508,042</b>	

## 11 NET INVESTMENT IN LEASE

The Company's net investment in lease includes the following:

	2009	2008
	\$	\$
Total estimated minimum lease payments receivable	2,729,998	3,605,747
Less: unearned income	(727,134)	(1,429,807)
	2,002,864	2,175,940
Less: current portion	(332,579)	(227,034)
	1,670,285	1,948,906

The estimated minimum lease payments receivable represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located and penalty payments resulting from temporary plant shut-downs. The lease expires April 2014, at which time the customer has the option to purchase the asset for \$1.

Future estimated minimum lease payments receivable under the sales-type lease are as follows:

	\$
2010	581,798
2011	560,400
2012	560,400
2013	560,400
2014	467,000
	2,729,998

## 12 INVESTMENT IN JOINT VENTURE

The Company has entered into a partnership agreement on November 7, 2007 with two partners established under the laws of the Peoples Republic of China with the name of Thermal Energy International (Guangzhou) Ltd. in which the Company owns a 55% interest. The Joint Venture has been established to market, sell and install

Thermal Energy International Inc.'s suite of products in China. The start-up capital required was \$200,000 CDN and each partner has contributed their respective share in 2009.

The consolidated financial statements include the Company's proportionate share of the revenue, expenses, assets and liabilities of the joint venture as follows:

	2009
	\$
Current assets	148,530
Current liabilities	11,188
Sales	79,017
Cost of sales	40,681
Other expenses	114,535
Net loss	(76,199)
Funds used in operations	(123,679)

### 13 BANK LOANS

At May 31, 2009, the Company had two bank loans aggregating to \$669,087. The first loan has an authorized amount of \$2,500,000. At May 31, 2009 this loan, secured by accounts receivable and a general security agreement, with interest rate at prime plus 0.25%, amounted to \$408,667 (May 31, 2008 - \$908,667) is guaranteed by the Export Development Corporation in an amount of USD \$215,540. Prime rate at May 31, 2009 was 2.25% (2008 - 4.75%).

In accordance with the loan agreement, the Company is subject to certain loan covenants and must meet certain financial ratios. At May 31, 2009 not all financial covenants were met.

At May 31, 2009, the second loan amounted to \$260,420 (May 31, 2008 - \$Nil). It is secured by certain trade accounts receivable of a subsidiary and carries a service charge of 0.805% of the gross loan subject to a minimum annual charge of approximately \$30,000 and an interest rate of 1.95% over the LIBOR rate. At May 31, 2009 the LIBOR rate was 0.5%.

### 14 RELATED PARTY TRANSACTIONS

Related party transactions, in the normal course of operations, are measured at the exchange value which represents the amounts established and agreed upon by both parties.

	2009	2008
Balances owing to/from directors		
Accounts receivable	\$60,786	\$34,450
Loans receivable, including accrued interest	\$381,139	\$289,647
Accrued liabilities	\$26,250	\$75,534
Directors share options and warrants outstanding at May 31		
Issued	3,500,000	3,500,000
Exercisable	2,961,000	2,461,000
Warrants outstanding	37,500	37,500
Balances owing from officers		
Accounts receivable	\$9,039	\$8,000
Loans receivable, including accrued interest	184,960	\$319,800

Balance owing from shareholders		
Loans receivable including accrued interest	321,971	-
Transactions with directors and officers were as follows:		
Directors fees for services	\$113,000	\$116,750
Officers fees for services	\$132,000	\$188,000
Shares issued to Directors	800,000	2,366,667
Shares issued to Officers	-	1,843,000

### 15 CAPITAL STOCK

	2009		2008	
	# Shares	\$	# Shares	\$
<b>Authorized</b>				
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, at \$0.01 at \$0.01 per share and convertible to common shares on a 1 to 1 basis at the rate of 20% of the number originally issued per year.				
<b>Class A Common shares issued</b>				
Balance, beginning of year	99,052,104	20,122,830	90,918,419	17,573,323
Issued in settlement of liabilities	50,000	17,500	350,685	104,848
Issued for loans (i)	430,000	94,600	-	-
Issued for cash, net of flow through share tax benefit (ii)	67,720,000	14,896,560	4,190,000	1,018,500
Issued as a result of the exercise of options for loans (iii)	350,000	146,840	3,593,000	1,426,159
	167,533,922	35,278,330	99,052,104	20,122,830
Less: loans outstanding to assist shareholders in purchasing capital stock (iv)		(827,351)		(643,751)
Share issue costs		(1,903,200)		-
Balance, end of year	167,533,922	32,547,779	99,052,104	19,479,079

(i) During the year, shares were issued to shareholders for loans which resulted in a stock-based compensation charge of \$56,100.

(ii) During fiscal 2009 the Company did not issue any flow-through common shares. In fiscal 2008, the Company renounced expenditures of \$615,000 from 4,190,000 flow-through common shares issued during the year. The resulting future income tax recovery of \$200,000 was charged against capital stock as share expenses.

(iii)

	2009	2008
	\$	\$
Loans to exercise options granted during the year		
Employees	-	123,000
Directors and officers	89,000	454,300
	89,000	577,300

Shares issued as a result of the exercise of options for loans has resulted in stock-based compensation expense in the following amounts:

	2009	2008
	\$	\$
Employees	-	26,523

Directors and officers	<b>24,100</b>	104,306
	<b>24,100</b>	130,829

(iv) Repayments made on these loans during the year ended May 31, 2009 were \$Nil (2008 - \$47,323)

	Loans to acquire shares	
	2009	2008
	\$	\$
President	<b>124,647</b>	124,647
Directors and Officers	<b>402,800</b>	313,800
Other shareholders	<b>299,904</b>	205,304
	<b>827,351</b>	643,751
Market value of shares held as security	<b>289,160</b>	1,131,015

Loans were extended to employees, shareholders, directors and officers to acquire shares of the Company through the exercise of options. These loans bear interest at a rate of 5% and mature at dates which range from 2 to 5 years from the date of issue. In certain instances, the borrower's liability in respect of these loans shall at all times be limited to the value of the underlying shares for which the loan was granted. They can be repaid in part or in full at any time before maturity, at which time the shares with an equivalent value to the repayment will be released to the borrower by the Company. The loans are secured by the share certificates.

Stock-based compensation on loans granted to Directors, officers and other shareholders was estimated using the Black-Scholes option pricing model with the following assumptions:

	Loans to exercise options		Loans to acquire shares	
	2009	2008	2009	2008
Weighted average assumptions:				
Expected dividend	<b>0%</b>	0%	<b>0%</b>	0%
Expected volatility	<b>79%</b>	80%	<b>79%</b>	98%
Risk-free interest rate	<b>2.50%</b>	4.50%	<b>2.50%</b>	4.50%
Expected option life in years	<b>1.0</b>	2.0	<b>1.0</b>	1.0

The Company has a five-year licensing and purchasing agreement with Mabarex for their Dry-Rex™ system ending September 8, 2011. Under the terms of this agreement, the Company is required to issue 125,000 common shares at \$0.16 each to Mabarex for each of the first two contracts to use the Dry-Rex™ system.

In addition, the Company is committed to issue 578,000 (2008 – 539,000) options to directors and shareholders to purchase common shares at \$0.16 per share, based on Company performance and which will expire on December 20, 2009.

## Warrants

(a) In fiscal 2008 the Company completed a private placement. Funds were raised by issuing units that included one Class A common share and one non-transferable share purchase warrant. In fiscal 2009, the Company completed a private placement and as a result, the agent was issued 5,236,363 transferable warrants, which have been valued at \$636,200. Activity in share purchase warrants was as follows:

	2009		2008	
	# Warrants	Weighted Average Exercise Price	# Warrants	Weighted Average Exercise Price
		\$		\$

Balance, beginning of period	<b>8,788,501</b>	<b>0.40</b>	14,480,390	0.35
Issued	<b>5,236,363</b>	<b>0.22</b>	1,517,500	0.50
Exercised	-	-	(392,828)	0.32
Expired	<b>(7,271,001)</b>	<b>0.37</b>	(6,816,561)	0.32
Balance, end of period	<b>6,753,863</b>	<b>0.28</b>	8,788,501	0.40

(b) The following table summarizes the status of warrants outstanding at May 31, 2009:

Warrants Outstanding	Exercise Price \$	Expiry Date
1,517,500	0.50	To December 7, 2009
5,236,363	0.22	To June 20, 2010
<b>6,753,863</b>		

## 16 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 2009 and 2008 had a vesting period of four months and eighteen months.

(a) Activity in stock options was as follows:

	2009		2008	
	# Options	Weighted Average \$	# Options	Weighted Average \$
Outstanding, beginning of period	<b>5,857,143</b>	<b>0.21</b>	8,368,000	0.17
Granted	<b>625,000</b>	<b>0.30</b>	1,850,000	0.30
Exercised	<b>(450,000)</b>	<b>0.25</b>	(4,210,857)	0.17
Forfeited	<b>(607,143)</b>	<b>0.34</b>	(150,000)	0.21
Expired	<b>(100,000)</b>	<b>0.24</b>	-	-
Outstanding, end of period	<b>5,325,000</b>	<b>0.20</b>	5,857,143	0.21
Number of options exercisable as at May 31	<b>4,747,000</b>	<b>0.21</b>	4,779,143	0.21

Options exercised during the period were as follows:

	2009		2008	
	# shares	\$	# shares	\$
Employees	<b>100,000</b>	<b>24,000</b>	1,885,857	320,300
Directors and Officers	<b>350,000</b>	<b>89,000</b>	1,750,000	265,000
Consultants	-	-	575,000	117,000
	<b>450,000</b>	<b>113,000</b>	4,210,857	702,300

In fiscal 2009, 350,000 options were exercised in consideration of loans receivable of \$89,000 (2008 - 3,593,000 for loans of \$577,300) and 100,000 options were exercised for cash of \$24,000 (2008 – 142,857 for debt of \$30,000 and 475,000 for cash of \$95,000).

(b) The following options are outstanding and/or exercisable at May 31, 2009:

Number of Options Outstanding	Number of Options Exercisable	Exercise Price Per Share \$	Expiry Date
3,000,000	2,422,000	0.16	December 20, 2009
500,000	500,000	0.20	March 15, 2010
250,000	250,000	0.37	June 11, 2010
100,000	100,000	0.43	July 20, 2010
500,000	500,000	0.20	January 25, 2011
250,000	250,000	0.29	April 29, 2011
250,000	250,000	0.27	May 16, 2011
225,000	225,000	0.33	August 15, 2011
250,000	250,000	0.25	September 9, 2011
5,325,000	4,747,000		

c) Stock-based compensation

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

	2009	2008
Expected dividend	0.00%	0.00%
Expected volatility	78%	88%
Risk-free interest rate	2.50%	4.50%
Expected option life in years	2.4	2.4

The weighted average fair value of stock options granted since the beginning of the year is \$0.17 (2008 - \$0.20).

Stock-based compensation expense related to the issuance of stock option is included in administration expense and is broken down as follows:

	2009	2008
	\$	\$
Employees	18,620	132,222
Consultants	5,320	114,235
Directors and Officers	84,959	118,500
	108,899	364,957

The grant date weighted average fair value of options granted during the year was \$0.17 (2008 - \$0.20).

## 17 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:

	2009	2008
	\$	\$
Loss before income taxes	(3,205,377)	(2,572,508)

Income taxes calculated using combined federal and provincial income tax rates in Canada of 33.5% (2008 - 35.45%)	(1,073,801)	(912,000)
Stock-based compensation	63,300	175,800
Other	19,600	3,300
Permanent differences	(279,800)	-
Expired losses during the year	364,100	-
Effect of change in tax rates	11,101	788,700
Effect of changes in valuation allowance	(895,500)	(255,800)
Future income tax provision (recovery)	-	(200,000)

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

	2009	2008
	\$	\$
Future income tax assets		
Non-capital losses	2,994,500	2,252,800
Intangible assets	835,600	794,300
Property, plant and equipment	476,000	707,200
Share issue costs	293,900	-
	4,600,000	3,754,300
Future income tax liabilities		
Lease adjustment	(580,800)	(631,000)
Net future income tax asset before valuation allowance	4,019,200	3,123,300
Valuation allowance	(4,019,200)	(3,123,300)
Net future income tax asset	-	-

In fiscal year 2008, the Company 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. During fiscal 2009, the Company did not renounce any expenditures (2008 - \$615,000). At May 31, 2009 and 2008 there are no expenditures that are required to be incurred before December 31, 2009. Participation in this program is subject to verification by tax authorities with respect to the nature and timing of expenditures.

As at May 31, 2009, the Company had available non-capital income tax loss carry forwards in the following amounts which may be used to reduce federal and provincial taxable income.

Year of Expiry	Amount \$
2010	1,395,000
2014	355,000
2015	533,000
2026	1,276,000
2027	1,693,000
2028	1,429,000
2029	3,651,000
Total	10,332,000

**18 INFORMATION INCLUDED IN CONSOLIDATED OPERATIONS**

	2009	2008
	\$	\$
Interest expense	42,915	15,223

Administration expense and selling, marketing and business development expense are presented net of government assistance of \$5,166 and \$20,203 (2008 - \$20,203 and \$196,922) respectively.

**19 PENSION PLAN**

The Company contributes to a defined contribution pension plan for permanent employees of one of its subsidiaries. The Company matches employee contributions. The plan and its assets are held by independent managers. The pension charge represents contributions paid by the company and amounted to \$20,866 for the year ended May 31, 2009 (\$Nil in 2008).

**20 SEGMENTED INFORMATION**

In fiscal 2009 and 2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America and Europe (only North America in 2008) and was also engaged in the start-up phase of similar operations in China. Within this business segment, the Corporation markets, sells, engineers, fabricates, constructs, installs and supports three retrofit technology lines – waste energy recovery solutions, air emission control solutions and condensate return system solutions. Assets are located in Canada and Europe.

The Company operated in three reportable segments in fiscal 2009 (two in 2008). In the waste energy recovery and air emission control business, customers finance these projects entirely from their own resources or through the Company's Thermal-AUD™ system whereby the Company finances the project and leases back the facility to the customer. This gives rise to two reportable segments. The third segment is in the condensate return system solutions business through its acquisition of Gardner Energy Management Limited (GEM™) on July 1, 2008. These three reportable segments are detailed below:

	Customer financed contracts and other		Thermal-AUD™ contract		GEM™	
	2009	2008	2009	2008	2009	2008
	\$	\$	\$	\$	\$	\$
Revenue from external customers	725,603	2,716,366	-	2,209,842	3,233,319	-
Inter-segment revenues	127,068	19,111	-	-	96,206	-
Interest and finance revenue	82,823	32,098	262,184	56,201	345	-
Interest and bank charges	7,623	13,503	30,870	6,914	66,573	-
Amortization of property, plant and equipment	29,754	31,314	-	-	21,466	-
Amortization of intangibles	-	-	-	-	170,958	-
Segment loss (profit)	2,882,752	2,391,014	(100,978)	(18,506)	423,603	-
Expenditures for property, plant and equipment	25,318	28,768	-	-	13,773	-
Expenditures for intangible assets	-	-	-	-	1,679,000	-
Expenditures for goodwill	-	-	-	-	3,449,799	-
Total assets	6,450,829	2,755,526	2,064,620	2,225,562	6,370,073	-

	2009	2008
	\$	\$
Reconciliation to financial statements		
Revenues		
Total revenues for reporting segments	4,182,196	4,945,319
Elimination of inter-segment revenues	(223,274)	(19,111)
Total company revenues	3,958,922	4,926,208
Loss		
Total loss for reported segments	3,205,377	2,572,508
Income tax recovery	-	(200,000)
Net loss	3,205,377	2,372,508
Assets		
Total assets for reported segments	14,885,522	4,981,088
Elimination of inter-segment receivables	(1,727,911)	(1,287,087)
Elimination of other inter-segment assets	(607,181)	-
Total assets	12,550,430	3,694,001

**Other significant items**

	2009			2008		
	Segment totals	Adjustments	Company totals	Segment totals	Adjustments	Company totals
	\$	\$	\$	\$	\$	\$
Interest and finance revenue	345,352	(5,277)	340,075	88,299	-	88,299
Interest and bank charges	105,066	(5,277)	99,789	20,417	-	20,417
Amortization of property, plant and equipment	51,220	-	51,220	31,314	-	31,314
Amortization of intangible assets	170,958	-	170,958	-	-	-
Expenditures for property, plant and equipment	39,091	-	39,091	28,768	-	28,768
Expenditures for intangible assets	1,679,000	-	1,679,000	-	-	-
Expenditures for goodwill	3,449,799	-	3,449,799	-	-	-

**Geographic Segments**

	Revenues		Property, plant & equipment	
	2009	2008	2009	2008
	\$	\$	\$	\$
Canada	53,028	2,382,444	60,630	65,066
United States	749,575	2,507,137	-	-
Europe	3,077,302	-	37,112	-
China	79,017	36,627	-	-

Total	3,958,922	4,926,208	97,742	65,066
	Goodwill & intangible assets		Net investment in lease	
	2009	2008	2009	2008
	\$	\$	\$	\$
Canada	-	-	2,002,864	2,175,940
United States	-	-	-	-
Europe	4,957,841	-	-	-
China	-	-	-	-
Total	4,957,841	-	2,002,864	2,175,940

Revenues from outside customers are attributed to the geographic segments based on the location of the project.

The Company has one new customer that accounts for 21% of revenue and a second customer that accounts for 14% (2008-46%) for the year ended May 31, 2009. In the prior year, the Company had a customer that accounted for 48% of revenue.

## 21 CAPITAL MANAGEMENT

The Company's objectives when managing capital is to safeguard the Company's ability to continue as a going concern and to maintain flexible capital structure for its projects for the benefit of its stakeholders. In the management of capital, the Company includes the components of shareholders' equity, excluding accumulated other comprehensive loss. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the Company may attempt to issue new shares. Management reviews the capital structure on a regular basis to ensure that objectives are met.

The Company's share capital is not subject to external restrictions; however the Company's bank loans include certain loan covenant and certain financial ratios. The Company was not in compliance with these covenant and ratios at May 31, 2009.

## 22 FINANCIAL RISK OBJECTIVES AND POLICIES, AND FINANCIAL RISKS

### Market risk

Market risk is the risk that changes in market prices, such as interest rates and foreign exchange, will affect the Company's net earnings or loss or the value of its financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximising returns.

### Interest rate risk

The Company has contracted short-term bank loans bearing floating rates of interest. These financial instruments expose the Company to risk in the event market interest rates fluctuate. These loans aggregated \$669,087 at May 31, 2009. Under the terms of the first loan agreement in the amount of \$408,667, it is expected that this loan will be fully retired within fiscal 2010. Any significant fluctuation in the interest rate during this period which would adversely affect the company is considered minimal. Any fluctuation in the interest rate on the second loan held by a subsidiary in the amount of \$260,420 is considered manageable.

### Foreign exchange risk

The Company is exposed to foreign exchange risk as follows:

	May 31, 2009			May 31, 2008
	US\$	£	Euros	US\$
Cash and cash equivalents	26,093	34,039	17,160	7,315
Accounts receivable	279,688	246,698	174,631	394,798
Inventories	-	300,254	11,337	-
Bank loans	-	69,967	86,563	-
Accounts payable	196,935	93,373	3,720	824,252
Accrued liabilities	-	144,964	19,042	-

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

The Company operates internationally with a subsidiary in the United Kingdom, a joint venture in China and operations in the United States. The Company incurs expenses and earns revenues in U.S. dollars, Euros and Chinese renminbi. The majority of the transactions are in U.S. dollars, GBP and Euros.

A 10% strengthening of the following currencies against the Canadian dollar would have had the following effect on operations in fiscal 2009:

	May 31, 2009			May 31, 2008
	US\$	£	Euros	US\$
Net loss (profit)	(19,800)	(33,000)	30,000	15,000

### Credit risk

The financial instruments that potentially expose the Company to credit risk are accounts receivable and money market funds.

The continuity of the allowance for doubtful accounts is as follows:

	2009	2008
	\$	\$
Opening balance	30,000	-
Increase during the year	30,000	30,000
Closing balance	60,000	30,000

### Liquidity risk

Liquidity risk management serves to maintain a sufficient amount of cash and cash equivalents and to ensure that the Company has financing sources such as bank loans for a sufficient authorized amount. The Company continues to actively seek external financing to ensure it has the necessary funds to fulfill its obligations.

### Fair value of financial instruments

The fair value of accounts receivable, accounts payables, accrued liabilities and bank loans approximate the carrying amounts given that they will mature shortly.

The fair value of money market fund is equivalent to the market value determined using the last bid price.

## 23 COMPARATIVE AMOUNTS

Certain 2008 amounts have been reclassified to conform with the current year's presentation.

**24 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:

	\$
2010	209,800
2011	86,000
2012	79,600
2013	70,300
2014	6,100
Total	451,800

**25 CONTINGENCY**

On October 20, 2005 the Company announced that the voluntary mediation between the Company and its past President had ended without resolution. On October 25, 2005 the Company had been served with a statement of claim for \$2.3 million from its past President. On December 2, 2005 the Company filed its statement of defence and filed a counterclaim seeking damages from the past President in the amount of \$5.4 million. The Company is confident in the merits of its own case and that the claim by the past President is frivolous and without merit and probability of loss is very low. Accordingly, no provision for any potential loss has been recorded in connection with this claim.

**26 RECENTLY ISSUED ACCOUNTING STANDARDS NOT YET IMPLEMENTED****Goodwill and intangible assets**

In February 2008, the CICA published Section 3064, "Goodwill and Intangible Assets" establishing standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets by profit-oriented companies. It clarifies the recognition of intangible assets and deals with the recognition of internally generated intangible assets.

The Company will implement this new standard in its first quarter of fiscal year 2010 and is currently evaluating the impact of its adoption on its consolidated financial statements.

**International Financial Reporting Standards ("IFRS")**

In February 2008, the CICA announced that Canadian GAAP for publicly accountable enterprises will be replaced by International Financial Reporting Standards ("IFRS") for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The standard also requires that comparative figures for 2010 be based on IFRS. The Company continues to monitor and assess the impact of convergence of Canadian GAAP and IFRS.

**Business Combinations, Consolidated Financial Statements and Non-controlling Interests**

In January 2009, the CICA issued Section 1582, "Business Combinations", Section 1601, "Consolidations", and Section 1602, "Non-Controlling Interests". These sections replace the former Section 1581, "Business Combinations", and Section 1600, "Consolidated Financial Statements". The standards apply to annual and interim financial statements relating to fiscal years beginning on or after January 1, 2011. Section 1582 establishes standards for the accounting for a business combination. It provides the Canadian GAAP equivalent to IFRS 3, Business Combinations (January 2008) and applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Section 1601, together with Section 1602, establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-

controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of IFRS IAS 27, Consolidated and Separate Financial Statements (January 2008). Earlier application of the standards is permitted. If an entity applies the Sections before January 1, 2011, it shall disclose that fact and apply Sections 1582, 1601 and 1602 at the same time. The Company is currently evaluating the impact of adopting the standards as part of its IFRS conversion plan.

# INFORMATION FOR SHAREHOLDERS

## Board of Directors

John Kelly, Chairman of the Board  
 R. James Ansell  
 William Crossland  
 Michael Williams

## Officers & Senior Management

William Crossland  
 President & Chief Executive Officer

Michael Williams  
 Interim Chief Financial Officer

Robert Triebe  
 Chief Technology Officer

Debbie Weinstein  
 Corporate Secretary

## Auditors

Raymond Chabot Grant Thornton LLP

## General Counsel

LaBarge Weinstein Professional Corporation

## Registrar & Transfer Agent

Computershare Investor Services, Inc.  
 100 University Avenue, 11th Floor  
 Toronto, ON M5J 2Y1  
 Tel: (416) 263-9496

## Stock Listing

The common shares of Thermal Energy International Inc., are traded on the TSX Venture Exchange ([www.tsxventure.com](http://www.tsxventure.com)) under the symbol "TMG"

## Investor Relations

William Crossland  
[bill.crossland@thermalenergy.com](mailto:bill.crossland@thermalenergy.com)  
 (613) 723-6776 x. 214

## Annual General Meeting

The Annual General Meeting of Shareholders will be held on:  
 Tuesday, November 19, 2009 at 9:00 am EST  
 Brookstreet Hotel  
 525 Legget Drive,  
 Ottawa, Ontario

## Offices

### HEAD OFFICE

Thermal Energy International Inc.  
 36 Bentley Ave  
 Ottawa ON, K2E 6T8  
 Tel: (613) 723-6776  
 Fax: (613) 723-7286

### U.K.

GEM  
 1 John Street  
 Bristol, U.K.  
 BS1 2HR  
 Tel: +44 (0) 117 917 7010  
 Fax: +44 (0) 117 917 7011

### CHINA

Thermal Energy International (Guangzhou) Ltd.  
 23C Wing King Plaza  
 No.29 Jianshe Liu Road  
 Guangzhou, China  
 PS: 510060

## Website

[www.thermalenergy.com](http://www.thermalenergy.com)  
[www.gemtrap.com](http://www.gemtrap.com)

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