

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

CONSOLIDATED BALANCE SHEETS

As at	(Unaudited) Aug 31 2007 \$	May 31 2007 \$
ASSETS		
Current assets		
Cash	246,382	549,196
Short term investments (note 4)	1,286,293	1,020,880
Accounts receivable (note 5)	333,505	428,581
Contracts in progress	33,000	4,000
Prepays and other assets	59,441	60,894
	1,958,621	2,063,551
Property, plant and equipment (note 6)	84,600	67,612
	2,043,221	2,131,163
LIABILITIES, CAPITAL STOCK, CONTRIBUTED SURPLUS AND DEFICIT		
Current liabilities		
Accounts payable	778,173	328,182
Accrued liabilities	144,547	158,082
Deferred revenue	530,447	1,000,000
Due to past President (note 7)	17,937	17,937
	1,471,104	1,504,201
Capital stock, contributed surplus and deficit		
Capital stock (note 8)	17,775,816	17,459,549
Contributed surplus (note 8)	1,928,270	1,881,487
Deficit	-19,131,969	-18,714,074
	572,117	626,962
	2,043,221	2,131,163

Contingency (note 15)

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

On behalf of the Board

	
Tim Angus President and CEO	Oliver Toffoli Chief Financial Officer

THERMAL ENERGY INTERNATIONAL INC.**CONSOLIDATED OPERATIONS AND DEFICIT**

Three months ended August 31

	2007	2006
	\$	\$
REVENUE		
Sales	1,048,357	102,659
Cost of sales	785,405	150,122
Gross profit (loss)	262,952	-47,463
Expenses		
Administration	284,273	122,260
Selling, marketing and business development	301,109	242,433
Legal fees	5,097	12,670
Audit fees	15,000	15,000
Insurance	30,176	18,828
Amortization of property, plant and equipment	7,693	6,413
Patent and trademark maintenance	-	4,932
Research and development	30,680	24,659
Interest and bank charges	2,987	1,201
Foreign exchange loss	18,507	1,591
	695,522	449,987
	-432,570	-497,450
Interest revenue	14,675	123
Other costs (note 11)	-	-14,684
Net loss	-417,895	-512,011
Deficit, beginning of period	-18,714,074	-16,270,809
Deficit, end of period	-19,131,969	-16,782,820
Net loss per share - basic and diluted	(0.005)	(0.007)
Weighted average number of common shares	91,505,729	74,669,876

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

THERMAL ENERGY INTERNATIONAL INC

CONSOLIDATED STATEMENTS OF CASH FLOWS

Three months ended August 31

	2007	2006
	\$	\$
OPERATING ACTIVITIES		
Net loss for the period	-417,895	-512,011
Add items not involving cash:		
Stock-based compensation charge	153,800	8,550
Amortization of property, plant and equipment	7,693	6,413
Changes in non-cash operating working capital		
Accounts receivable	120,076	418,088
Contracts in progress	-29,000	89,000
Prepays and other assets	1,453	-24,531
Accounts payable	468,741	-62,573
Accrued liabilities	-13,535	77,220
Deferred revenue	-469,553	17,000
Net cash used in operating activities	-178,220	17,156
INVESTING ACTIVITIES		
Acquisition of short-term investments	-265,413	-
Additions to property, plant and equipment	-24,681	-32,901
Net cash used in investing activities	-290,094	-32,901
FINANCING ACTIVITIES		
Common shares issued (note 8)	140,500	-
Decrease in loan receivable	25,000	18,500
Net cash provided by financing activities	165,500	18,500
Increase (decrease) in cash for the period	-302,814	2,755
Cash beginning of period	549,196	59,119
Cash end of period	246,382	61,874
Interest paid	2,390	644
Fair value of options exercised for cash	107,017	-

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1 GOVERNING STATUTES AND NATURE OF OPERATIONS

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

2 GOING CONCERN

The Company incurred losses from operations in the quarters ended August 31, 2007 and 2006.

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

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

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

3 BASIS OF PRESENTATION AND ACCOUNTING CHANGE

The accompanying interim unaudited consolidated financial statements of Thermal Energy International Inc. have been prepared by management in accordance with Canadian generally accepted accounting principles applicable to interim consolidated financial statements and do not include all the information required for complete financial statements. The interim unaudited consolidated financial statements and accompanying notes should be read in conjunction with the audited consolidated financial statements and accompanying notes for the year ended May 31, 2007. These interim consolidated financial statements are also prepared in accordance with the accounting policies described in the Company's audited consolidated financial statements for the year ended May 31, 2007 except for the changes in accounting policies described below.

Effective June 1, 2007, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants (CICA) under CICA Handbook Section 1530, Comprehensive Income, Section 3251, Equity, Section 3855, Financial Instruments; Recognition and Measurement, Section 3861, Financial Instruments; Disclosure and Presentation and Section 3865, Hedges. These new Handbook sections provide requirements for the recognition and measurement of financial instruments and on the use of hedge accounting.

Under Section 3855, all financial instruments are to be classified into one of five categories and measured at fair value except for loans and receivables, held-to maturity investments and other financial liabilities which are to be measured at amortized cost. Held-for-trading financial assets are to be measured at fair value and changes in fair value are to be recognized in net income. Available-for-sale financial instruments are to be measured at fair value with changes in fair value recorded in other comprehensive income until the instrument is derecognized or impaired. Section 1530 establishes standards for the reporting of comprehensive income, defined as the change in equity from transactions and other events from non-owner sources.

Adoption of these new recommendations resulted in the following impacts on the classification and measurement of the Company's financial instruments, which were previously recognized at cost:

- Cash is classified as a held-for-trading financial asset. It is measured at fair value and changes in fair value are recognized in net earnings. This change had no impact on the financial statements as at August 31, 2007;
- Short-term investments are classified as available-for-sale. Since the fair value and the cost base of the Company's short-term investments was the same on June 1, 2007, there was no adjustment to the opening fair value of short-term investments.
- 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. Other receivables are recognized at amortized cost using the effective interest method, less any impairment. This change had no impact on the financial statements as at August 31, 2007;
- Accounts payable, accrued liabilities and amounts due to past President are classified as other financial liabilities. They are valued at amortized cost using the effective interest method. This change had no impact on the financial statements as at August 31, 2007.

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

4 SHORT TERM INVESTMENTS

Short term investments consist of excess cash invested in money market funds.

5 ACCOUNTS RECEIVABLE

	Aug 31, 2007	May 31, 2007
	\$	\$
Trade	257,744	377,124
Other	75,761	51,457
	333,505	428,581

At August 31, 2007 85% (May 31, 2007 – 94%) of trade receivables were from one customer.

6 PROPERTY, PLANT AND EQUIPMENT

	Aug 31, 2007		May 31, 2007	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Furniture and fixtures	81,671	63,588	81,671	62,597
Laboratory equipment	52,857	15,883	46,675	14,183
Computers	153,774	136,281	140,166	133,675
Software	16,971	12,692	12,081	12,081
Leasehold improvements	21,401	13,630	21,401	11,846
	326,674	242,074	301,994	234,382
Accumulated amortization	(242,074)		(234,382)	
Net book value	84,600		67,612	

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

7 RELATED PARTY TRANSACTIONS

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

	Aug 31, 2007 \$	Aug 31, 2006 \$
Transactions with and balances owing to/from directors		
Fees for services	15,000	4,500
Loans receivable	71,969	97,000
Accrued liabilities	9,375	-
Common shares issued	287,500	-
Flow-through shares issued	-	200,000
Directors share options outstanding at Aug 31		
Issued	3,750,000	2,300,000
Exercisable	2,983,000	1,985,000
Transactions with and balances owing to/from officers		
Fees for services	51,000	48,000
Accounts receivable	-	2,955
Loan receivable	7,500	-
Common shares issued	-	75,000
Flow-through shares issued	-	-
Officers share options outstanding at Aug 31		
Issued	1,993,000	1,043,000
Exercisable	1,726,000	885,500

There were no changes in the amount due to the past President in the quarters ended August 31, 2007 and 2006. The balance due at August 31, 2007 was \$17,937 (2006 - \$17,937). There are no fixed repayment terms and the amount is non-interest bearing.

8 CAPITAL STOCK AND CONTRIBUTED SURPLUS

	Quarter Ended Aug 31, 2007		Year Ended May 31, 2007	
	# Shares	\$	# Shares	\$
Authorized				
Unlimited number of Class A common shares, no par value				
Unlimited number of Series 1 preferred shares, voting only in the case of dissolution of the Company, redeemable at the option of the Company convertible to common shares on a one to one basis at the rate of 20% of the number originally issued per year.				
Class A Common shares issued				
Balance, beginning of period	90,918,419	17,573,323	74,570,256	14,733,084
Issued in settlement of liabilities	37,500	18,750	1,160,584	181,393
Issued for cash, net of flow through share tax benefit (i)	-	-	15,137,579	2,645,846
Issued as a result of the exercise of options and warrants	780,000	272,517	50,000	13,000
	91,735,919	17,864,590	90,918,419	17,573,323
Less: loans outstanding to assist a shareholder in purchasing capital stock (ii)		(88,774)		(113,774)
Balance, end of period	91,735,919	17,775,816	90,918,419	17,459,549

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

(i) In fiscal 2007, the Company renounced expenditures of \$540,000 from 3,484,334 flow-through common shares issued during fiscal 2007; as a result, a future income tax recovery of \$195,000 was charged against capital stock.

(ii) A balance of \$46,969 is outstanding on shareholder loans to the President to purchase shares, \$7,500 for a loan to an officer and \$34,305 to other shareholders. These loans are due upon demand, bear no interest and have no fixed repayment terms. Stock-based compensation on these loans was estimated using the Black-Scholes option pricing model with a weighted average volatility assumption of 98% (74% fiscal 2007) and for all years an expected dividend rate of 0%, risk free interest rate of 4.50% (3.85% in fiscal 2007) and an expected life of one year.

The Company has a five year licensing and purchasing agreement with Mabarex for their Dry-Rex™ system. 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 976,217 options to directors and officers to purchase common shares at \$0.16 per share based on Company performance, and which will expire on December 20, 2009.

(a) The Company completed private placements. The funds were raised by issuing Units that included one Class A common share and one non-transferable share purchase warrant. Activity in share purchase warrants was as follows:

	Aug 31, 2007		Aug 31, 2006	
	# Warrants	Weighted Average Exercise Price	# Warrants	Weighted Average Exercise Price
		\$		\$
Balance, beginning of quarter	14,480,390	0.35	10,154,896	0.30
Issued	-	-	-	-
Exercised	(305,000)	0.33	-	-
Expired	(3,153,666)	0.35	-	-
Balance, end of quarter	11,021,724	0.35	10,154,896	0.30

(b) The following table summarizes the status of warrants outstanding at August 31, 2007:

Warrants Outstanding	Exercise Price \$	Expiry Date
3,742,895	0.30	To April 22, 2008
760,000	0.30	To October 10, 2008
260,000	0.30	To November 2, 2008
236,912	0.30	To November 30, 2008
324,000	0.30	To December 6, 2008
281,250	0.30	To December 29, 2008
4,166,667	0.40	To May 23, 2009
1,250,000	0.40	To May 29, 2009
<u>11,021,724</u>		

Contributed surplus

	Aug 31, 2007	May 31, 2007
	\$	\$
Balance, beginning of period	1,881,487	1,509,232
Stock-based compensation	153,800	377,755
	2,035,287	1,886,987
Fair value of options exercised and transferred to capital stock	107,017	5,500
Balance, end of period	1,928,270	1,881,487

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

9 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:

	\$
2008	78,600
2009	95,600
2010	82,200
2011	4,800
2012	4,800
Total	266,000

10 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 the quarter ended August 31, 2007 had vesting periods of four months. There were no options granted in the quarter ended August 31, 2006.

(a) Activity in stock options was as follows:

	Quarter ended Aug 31, 2007		Quarter ended Aug 31, 2006	
	# Options	Weighted Average \$	# Options	Weighted Average \$
Outstanding, beginning of quarter	8,368,000	0.17	4,718,714	0.17
Granted	750,000	0.17	-	-
Exercised	(475,000)	0.14	-	-
Cancelled/expired	-	-	(200,000)	0.18
Outstanding, end of quarter	8,643,000	0.17	4,518,714	0.17
Number of options exercisable as at August 31	6,526,000		3,942,464	

Options exercised were as follows:

	Quarter ended Aug 31, 2007		Quarter ended Aug 31, 2006	
	# Shares	\$	# Shares	\$
Employees	175,000	0.13	-	-
Directors	250,000	0.13	-	-
Consultants	50,000	0.20	-	-
	475,000	0.14	-	-

All options were exercised for cash other than \$25,000 of options issued in exchange for a loan due from the President.

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

(b) The following options are outstanding and/or exercisable at Aug 31, 2007:

Number of Options Outstanding	Number of Options Exercisable	Exercise Price Per Share \$	Expiry Date
193,000	193,000	0.10	January 12, 2008
250,000	250,000	0.20	January 24, 2008
750,000	750,000	0.10	February 1, 2008
500,000	500,000	0.12	February 1, 2008
150,000	150,000	0.24	March 1, 2008
800,000	800,000	0.22	April 29, 2008
250,000	250,000	0.24	May 19, 2008
100,000	100,000	0.24	June 2, 2008
150,000	150,000	0.24	June 10, 2008
150,000	150,000	0.24	August 15, 2008
250,000	250,000	0.26	September 9, 2008
350,000	350,000	0.21	September 7, 2009
3,500,000	2,133,000	0.16	December 20, 2009
500,000	500,000	0.20	March 15, 2010
350,000		0.37	June 11, 2010
300,000		0.35	June 15, 2010
100,000		0.43	July 20, 2010
8,643,000	6,526,000		

c) Stock-based compensation to employees

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

	Aug 31, 2007	Aug 31, 2006
Weighted average assumptions:		
Expected dividend	0.00%	-
Expected volatility	95%	-
Risk-free interest rate	4.5%	-
Expected option life in years	2.4	-
Fair value	0.25	-

There were no options granted in the period ended August 31, 2006.

Stock-based compensation expense in the quarter ended August 31, 2007 includes an amount of \$19,800 for options granted to consultants (2006- \$Nil). Employee stock-based compensation expense in the quarter ended August 31, 2007 is \$134,000 (2006 - \$8,550).

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OTHER COSTS

In the quarter ended August 31, 2007 there were no other costs. In the quarter ended August 31, 2006 other costs in the amount of \$14,684 were incurred to remedy a design deficiency of a project.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

12 SEGMENTED INFORMATION

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

One unaffiliated customer accounted for 98% of sales in the quarter ended August 31, 2007 and two unaffiliated customers accounted for 100% of sales in the quarter ended August 31, 2006. The Company continues to work aggressively with other partners and potential new partners to attract new customers.

13 FINANCIAL INSTRUMENTS

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

The Company is exposed to foreign exchange risk due to cash, short-term investments, accounts receivable and accounts payable denominated in U.S. dollars. As at August 31, 2007, assets denominated in U.S. dollars are cash, short-term investments and accounts receivable totalling US\$1,017,077 (US\$21,836 at August 31, 2006) and liabilities denominated in U.S. dollars are accounts payable totalling US\$476,996 (US\$19,663 at August 31, 2006).

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

14 COMPARATIVE AMOUNTS

Certain 2006 amounts have been reclassified to conform with the current period's presentation.

15 CONTINGENCY

On October 20, 2005 the Company announced that the voluntary mediation between the Company and its past President had ended without resolution. The Company has been served with a statement of claim for approximately \$4 million from its past President. The Company has filed its statement of defence and has 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 the Company will defend it vigorously. Accordingly, no provision for any potential loss has been recorded in connection with this claim.

16 RECENTLY ISSUED ACCOUNTING STANDARDS NOT YET IMPLEMENTED

Capital disclosures and financial instruments disclosures and presentation

In December 2006, the CICA issued three new standards: Section 3862 "Financial Instruments – Disclosures", Section 3863 "Financial Instruments – Presentation" and Section 1535 "Capital Disclosures". These three new standards are applicable to fiscal years beginning on or after October 1, 2007.

Section 3862 describes the required disclosures related to the significance of financial instruments on the entity's financial position and performance and the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. This Section complements principles of recognition, measurement and presentation of financial instruments of Section 3855 "Financial Instruments – Recognition and Measurement", 3863 "Financial Instruments – Presentation" and 3865 "Hedges".

Section 3863 establishes standards for presentation of financial instruments and non-financial derivatives. It complements standards of Section 3861 "Financial Instruments – Disclosure and Presentation".

Section 1535 establishes standards for disclosing information about an entity's capital and how it is managed to enable users of financial statements to evaluate the entity's objectives, policies and procedures for managing capital.

The Company will implement these three new standards in its first quarter of fiscal year 2009 and is currently evaluating the impact of their adoption on its consolidated financial statements.



**First QUARTER REPORT
Period Ended August 31, 2007**

MANAGEMENT DISCUSSION AND ANALYSIS

The following discussion explains material changes in the Corporation's financial condition and results of operations for the first quarter of fiscal year 2008, ended August 31, 2007. The quarterly financial statements constitute an integral part of the discussion and should be read in conjunction with these comments.

Description of Business

Thermal Energy has established itself since 1987 as a leading provider of cost-effective energy conservation and environmental compliance (air) products and solutions. Thermal Energy is providing its integrated turnkey solutions for customers to economically reduce multiple air pollutant emissions while deriving substantial energy savings benefits through advanced heat recycling. Thermal Energy's innovative abilities and unique technologies have ensured that the implemented solutions met or exceeded the air pollution control performance expectations, while at the same time generated sufficient renewable energy and operating cost savings to produce an attractive return on investment ("ROI"), thereby causing the solution to be self-financing.

Thermal Energy has developed cost-effective energy conservation and air compliance solutions for efficiently removing and reducing multiple air pollutant emissions including: Nitrogen Oxides (NOx) "Smog", Sulfur Oxides (SOx) "Acid Rain", Carbon Dioxide (CO2) "Greenhouse Gas", Fine Particulate Matter (PM2.5) "Lung Irritants", Heavy Metals (HM) including, Toxic Organic Compounds (TOC) "Poisonous", and Volatile Organic Compounds (VOC) "Odorous or Toxic".

More information on Thermal Energy can be found at www.thermalenergy.com. FLU-ACE®, THERMALONOX™, THERMALOZOMAX™, DRY-REX™, THERMAL-AUD™ and OPTINOX™ are trademarks of Thermal Energy, GEM® is a registered trademark used under licence from Gardner Energy Management Ltd. Common shares of Thermal Energy are traded on the TSX Venture Exchange under the symbol TMG.

Discussion of Operations and Financial Conditions

Revenue and Gross Profit

Total sales for the first quarter ended August 31, 2007, at \$1,048,357, increased substantially from \$102,659 in 2006. The increase in revenues from the previous year was due to progress on two new contracts with Johnson Controls (JCI) and reflected revenues from the sale of GEM® products in Canada, USA and China, and small residual revenues from completed work at the Centre Hospitalier Universitaire de Québec (CHUQ).

Gross profit (loss) for the first quarter ended August 31, 2007 at \$262,952 (25.08%) compared with \$(47,463) (-46.23%) in 2006. The gross profit is



significantly higher on a comparative basis from the same period in 2006 resulting from significantly higher revenues associated with undertaking two projects in parallel which were on time and on budget.

Expenses

Administration expenses in the first quarter ended August 31, 2007 were \$284,273 a significant increase of \$162,013 or 132.52% over the \$122,260 incurred in 2006. The increases were mainly as a result of increases of \$33,455 in staff charges, \$78,619 in allocated stock-based compensation, \$8,239 from additional computer software programs, \$10,500 for Directors' fees, \$4,668 from additional news release costs and \$9,816 from engineering training.

Selling, marketing and business development expenses in the first quarter ended August 31, 2007 were \$301,109, an increase of \$58,676 or 24.20% over \$242,433 in 2006. The main contributor of the increase year over year was the value of the stock option benefit expense of \$71,465 related to sales staff.

Legal expenses in the first quarter ended August 31, 2007 were \$5,097, a small decrease over the \$12,670 incurred in 2006. The main contributing factor is a decrease in production of litigation briefs and meetings year over year as the Company is waiting for a period of discoveries to begin with respect to ongoing litigation with the past President and an insurance company.

Audit fee provision in the first quarter ended August 31, 2007 was \$15,000, the same as 2006.

Insurance costs in the first quarter ended August 31, 2007 were \$30,176 an increase of \$11,348 compared to \$18,828 in 2006 due to new coverage of Errors & Omission (E&O) insurance.

Amortization of property, plant and equipment was at \$7,693 in the first quarter ended August 31, 2007 compared with \$6,413 in 2006, due primarily to the amortization of leasehold improvements associated with a new office lease and the acquisition of research and development test equipment.

Patent and Trademark maintenance costs were \$Nil in the first quarter ended August 31, 2007, compared to \$4,932 in 2006. All Patent and Trademark costs incurred by the Company are expensed as incurred.

Research and Development costs were \$30,680 in the first quarter ended August 31, 2007, compared to \$24,659 in 2006. The similar results demonstrate the continued laboratory testing following the Company's decision to resume work in developing its patented THERMALONOX™ technology through laboratory testing.

Interest and bank charges were at \$2,987 in the first quarter ended August 31, 2007 compared with \$1,201 in 2006.

Foreign exchange loss on US dollar transactions increased in the first quarter ended August 31, 2007 to \$18,507 compared with \$1,591 in 2006, the result of the increasing value of the Canadian dollar.



Interest revenue amounted to \$14,675 in the first quarter ended August 31, 2007 compared with \$123 in 2006 as a result of increased interest from short-term investments.

Other Costs were \$Nil in the first quarter ended August 31, 2007, compared to \$14,684 in 2006, which were additional costs to remedy the design deficiencies at the Valley Regional Hospital. Remedies are being sought through the courts to recover some or all of these costs.

Net Loss was \$417,895 in the first quarter ended August 31, 2007 compared to a net loss of \$512,011 in 2006. Contributing factors resulting in the loss in 2007 were non-monetary compensation amounting to \$153,800, increase in staff salaries and associated costs amounting to \$27,760, increase of \$8,240 in computer supplies and services, increase of \$11,348 in E&O insurance coverage and insufficient sales volume to cover the current level of fixed costs in the Company and to produce a net profit. Management continues to work hard to control overhead costs but its main focus at the present time is a dedicated effort to secure much improved sales results. This is discussed more fully elsewhere in this report.

Liquidity and Solvency

At August 31, 2007, the Company had working capital of \$487,517 compared to \$559,350 at May 31, 2007. Current assets of \$1,958,621 declined by \$104,930 from May 31, 2007. Accounts receivable were lower by \$95,076, contracts in progress increased by \$29,000 and cash and short-term investments declined by \$37,401. Current liabilities at \$1,471,104 decreased by \$33,097 from May 31, 2007. Increases of \$449,991 in accounts payable together with declines of \$13,535 in accrued liabilities were offset by a substantial decrease in deferred revenue of \$469,553, to \$530,447, which will be earned in subsequent periods.

Management continues to recognize the requirement to further improve 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.

Additionally, the Company is engaged in discussions to structure a multi-million dollar financing arrangement with investors. The additional proceeds raised would be used for expanded sales and marketing efforts and R&D activities with THERMALONOX™.

Related Party Transactions

In the quarter ended August 31, 2007, Directors fees for services were \$15,000 compared with \$4,500 in 2006. Officers fees for services were \$51,000 compared with \$48,000. Loans to acquire shares by a Director was \$71,969 at August 31, 2007 compared with \$97,000 at August 31, 2006. Loans to acquire shares by an officer amounted to \$7,500 at August 31, 2007 compared with \$Nil at August 31, 2006. 287,500 common shares were issued to Directors during the quarter ended August 31, 2007 of which, 250,000 were the result of the exercise of options.



Supplementary Financial Information

The following table shows selected consolidated financial data for the most recent eight quarters. The quarterly information has been prepared on the same basis as the consolidated financial statements.

Quarterly financial information (unaudited)
For the eight quarters ended August 31, 2007

	2006			2007				2008
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Sales	807,364	655,010	1,000,787	102,659	127,987	108,199	482,179	1,048,357
Net loss	1,008,669	402,164	425,289	512,011	689,150	520,155	721,949	417,895
Net loss per share basic and diluted	0.015	0.006	0.006	0.007	0.009	0.007	0.008	0.005

Trend Analysis:

The losses incurred in each quarter from Q2 FY 2006 through to Q1 FY 2008 are consistent in magnitude, with the exception of Q2 FY 2006 and all quarters in FY 2007.

The losses in Q2 FY 2006 of \$1,008,669 were due to operational losses of \$549,009 on the Camco, Valley Regional Hospital and Stratford General Hospital projects and decreased to \$402,164 in Q3 FY 2006.

The losses in Q1 FY 2007 increased to \$512,011 from \$425,289 in Q4 FY 2006 due to additional operational costs to complete the Minas Basin and Stratford General Hospital projects.

The losses in Q2 FY 2007 increased to \$689,150 from \$512,011 in Q1 FY 2007 due to a one-time charge to retire a previous shareholder loan of \$151,500 made to the past President to purchase shares in 1999 and due to the initial payment of \$40,000 for the Mabarex rights to their patented DRY-REX™ product.

The losses in Q3 FY 2007 decreased to \$520,155 from \$689,150 in Q2 FY 2007 due mainly to a future income tax recovery provision of \$195,000 arising from the renouncing of \$540,000 expenditures on 3,484,334 flow-through common shares.

The losses on Q4 FY 2007 increased to \$721,949 from \$520,155 in Q3 FY 2007 mainly due to an expense of \$133,000 in stock-based compensation and \$77,000 in sales commissions.

Without the exceptions noted above, the net losses remained in a fairly constant range throughout the eight quarters summarized from Q2 FY 2006 through Q1 FY 2008, demonstrating the need to significantly increase sales to cover and



exceed the amount of fixed costs in order to overcome the consistent pattern of losses.

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are designed to provide assurance that all relevant information is gathered and reported to senior management, including the Company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), on a timely basis so that appropriate decisions can be made regarding public disclosure. Management of the Company, with the participation of the CEO and the CFO, has evaluated the effectiveness of the Company's disclosure controls and procedures as at August 31, 2007 as required by Canadian securities laws. Based on that evaluation, the CEO and CFO have concluded that, as of August 31, 2007, the disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the Company's interim filings (as such terms are defined under Multilateral Instrument 52-109 Certification of Disclosure in Issuer's Annual and Interim Filings) and other reports filed or submitted under Canadian securities laws is recorded, processed, summarized and reported within the time periods specified by those laws and that material information is accumulated and communicated to management of the Company, including the CEO and CFO, as appropriate to allow for accurate disclosure to be made on a timely basis.

Changes in Internal Control over Financial Reporting

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. The CEO and CFO have concluded that there has been no change in the Company's internal control over financial reporting at August 31, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company has recognized the need to improve internal control by a better segregation of duties in the accounting and finance area. An Administrative assistant/accounting clerk has been added to relieve the current accountant of bookkeeping duties and enable the Company to devote more resources to the controllership function.

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 for the quarter ended August 31, 2007, these statements were not 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 standard, hybrid, and multi-air pollutant FLU-ACE® technology solutions. In addition, the Company has not yet been able to finance and complete the development and commercialization of its patented THERMALONOX™ technology. The THERMALONOX™ patented technology is yet to be tested however the Company had signed an agreement with the South China University of Technology (SCUT) with Chinese backing to jointly research and develop industrial applications for the Company's technology. The R&D program envisions demonstrating THERMALONOX™ on a coal-fired power plant slip stream in the Guangdong province which has been tentatively identified by SCUT as a suitable test site. Cost Effective Energy Conservation and Environmental Compliance Solutions Sales through cooperation with JCI has not limited the size of the market but has increased the market potential.

Financial risks and uncertainties of the Company include:

- The Company's history of operating losses and uncertainty of future profitability;
- The ability to continue to grow sales by maintaining its cooperation with JCI and through its THERMAL-AUD program;
- 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 Company'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; and
- The ongoing litigation with its former President & CEO.

Management's addressing of the risks:

The management of the Company realizes that the operating losses of the period ended August 31, 2007, 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 behind it, the Company is now fully focused on sales and marketing and is expanding its drive towards that purpose with the addition of a new Vice-President of Sales and a new Account Manager, Solution Sales to oversee the regional sales associates in Canada, the U.S. and Mexico.



The costs in the first quarter 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 continue to grow sales by maintaining its cooperation with JCI as evidenced by two recent contracts performed for its clients in the U.S. In addition there are numerous projects that it is jointly pursuing with JCI both in Canada and the U.S and abroad.

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 Thermal-AUD's 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.

The new 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 and with gross proceeds of \$1,968,500 in Q4 FY 2007. In addition it has realized in excess of \$600,000 in the same period of time through the closing of smaller private placements and the exercise of options and warrants.

Management believes that by maintaining its small core of personnel 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 Q1 and Q2 FY 2008 depending on the demand arising from increased sales volumes.

Management has acquired new licenses and distributorship rights to GEM®, a leading European (Great Britain) line of industrial/commercial steam traps; THERMALOZOMax™, an ozone generation technology 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, Alberta Envirofuels Inc., Rogers Sugar, CFB Kingston, Catalyst Paper and Lee & Man Paper Manufacturing Co. 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.

Management believes that competition against its core technology of FLU-ACE™ is limited at this time and believes that the market place is sufficiently large enough to permit stronger competition in the future. 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.



Highlights

On June 15, 2007 the Company announced the appointment of Anthony J. Pugliese as Vice President, Sales. Mr. Pugliese came from Direct Energy Business Services where he was Manager, Business Development, Health Care Sector, responsible for leading the development and implementation of market strategies in the Canadian healthcare and public sector markets. Prior to his tenure at Direct Energy, Mr. Pugliese was Account Manager, Healthcare Solutions with Johnson Controls, Inc. in eastern Canada.

On June 19, 2007 the Company announced that it had signed a Memorandum of Understanding to develop a joint venture with the Jiangnan Boilers and Pressure Vessels Company, Ltd. (JBPV), to deploy the Company's energy recovery solutions in key Chinese markets. JBPV, with revenues of \$90 million annually, serves the chemical fertilizer, medical, oil and chemical industries in China and works with a number of international companies such as York International, BASF, SECCO, Inc., and SPX Corp.

On June 21, 2007 the Company announced that it had formalized a research and development agreement with South China University of Technology (SCUT) focused on the commercialization of the Company's THERMALONOX™ nitrogen oxides (NOx) removal technology for China's coal-fired power market. The formal agreement opened the door for the initial Chinese investment in the research of \$1 million RMB (the lawful currency of the People's Republic of China) or (CAD\$140,000) by the Guangzhou Municipal Science and Technology Bureau for SCUT's project resources commitment to the Company. The funding was secured in Q1 FY 2008.

On June 26, 2007 the Company announced that it had signed a letter of intent to enter its first long-term energy services agreement with one of the largest North American forest products pulp and paper process, which has a wide-spread, repeatable, application for the industry. The agreement envisages an initial five-year solution to provide the customer with approximately \$2.5 M in positive cash flow and to cut greenhouse gas emissions by 50,000 tons of CO₂.

On June 28, 2007 the Company announced that it reached an agreement with Gardner Energy Management of Bristol, UK, to market its GEM® Condensate Return System in China. China represents a multi billion dollar market for condensate return systems and is the fastest growing steam systems market in the world.

On July 11, 2007 the Company announced that one of the largest pulp and paper manufacturers in China was commencing a trial installation of the GEM® Condensate Return System.

On August 7, 2007 the Company announced that it had received its first order in China for GEM® Steam Traps from Lee and Man Paper Manufacturing Co. to be installed on one of its paper machines in one of their massive plants that produces over 1.5 million tons of containerboard annually. Lee and Man will monitor the results as a basis for considering other conversions of their large condensate systems at their various plants.



On August 9, 2007 the Company announced that it had ventured into Alberta's oil, gas and petrochemical sector with a contract from an Edmonton-area petrochemical manufacturer, to begin retrofitting approximately one-third of its mid-size facility with GEM® steam traps.

On August 15, 2007 the Company announced the establishment of ForEverGreen Energy Inc., a wholly-owned green energy services subsidiary. The subsidiary will own and operate the Company's assets to be used under the Thermal AUD™ (Alternate Utility Delivery) program, that will allow the Company's customers to benefit from energy savings without capital investments. The Company will derive its revenues from the sale of assets to, and investments in the subsidiary.

On August 27, 2007 the Company announced that its wholly-owned energy services subsidiary, ForEverGreen Energy Inc. (FEI) signed an agreement for up to \$3.75M with Fraser Paper Inc. to recover waste heat at its Thurso Mill. The green power agreement using Thermal-AUD's (Alternative Utility Delivery) program is for a term of six years. The Company will enter into a contract with FEI to supply, install and manage performance of its FLU-ACE® system at the Thurso pulp mill.

Subsequent Events

On September 18, 2007 the Company announced that it had signed a Letter of Intent with an Eastern Canada pulp and paper mill for a DRY-REX® biomass drying system to dry the mill's biomass waste stream including paper sludge for use as biofuel. The feasibility study will be completed in December, 2007 and if accepted by the mill, would lead to a contract to implement the DRY-REX® system using the Thermal-AUD™ program through Thermal's energy services subsidiary (FEI).

In October 3, 2007, the Company announced that it had received three new initial orders for the "no fail" GEM® steam traps and an engineering contract from an existing customer involving the optimization of an older FLU-ACE® waste heat recovery system and steam system. The total value of the contracts is in excess of \$125,000.

Signed in Ottawa, Ontario on this 30th day of October, 2007.

A handwritten signature in black ink that reads "Tim Angus".

Tim K. Angus
President and CEO

A handwritten signature in black ink that reads "Oliver Toffoli".

Oliver Toffoli, P.Eng
General Manager & CFO