



An Innovative Technology Company Providing
Custom Energy and Emission Reduction Solutions

Consolidated Financial Statements and Management's Discussion and Analysis

Fiscal Year 2007 ended May 31, 2007

Auditors' Report

To the shareholders of
Thermal Energy International Inc.

We have audited the consolidated balance sheets of Thermal Energy International Inc. as at May 31, 2007 and 2006 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 2007 and 2006 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 18, 2007

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

CONSOLIDATED BALANCE SHEETS

As at May 31

	2007	2006
	\$	\$
ASSETS		
Current assets		
Cash	549,196	59,119
Short term investments (note 4)	1,020,880	-
Accounts receivable (note 5)	428,581	626,495
Contracts in progress	4,000	89,000
Prepays and other assets	60,894	41,777
	<u>2,063,551</u>	<u>816,391</u>
Loans receivable (note 6)	-	55,500
Property, plant and equipment (note 7)	67,612	59,539
	<u>2,131,163</u>	<u>931,430</u>

LIABILITIES, CAPITAL STOCK, CONTRIBUTED SURPLUS AND DEFICIT

Current liabilities		
Accounts payable	328,182	947,063
Accrued liabilities	158,082	166,728
Deferred revenue	1,000,000	99,000
Due to past President (note 8)	17,937	17,937
	<u>1,504,201</u>	<u>1,230,728</u>
Capital stock, contributed surplus and deficit		
Capital stock (note 9)	17,459,549	14,462,279
Contributed surplus (note 9)	1,881,487	1,509,232
Deficit	-18,714,074	-16,270,809
	<u>626,962</u>	<u>-299,298</u>
	<u>2,131,163</u>	<u>931,430</u>

Contingency (note 17)

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



On behalf of the Board

Tim Angus
 President and C.E.O.



Oliver Toffoli
 Chief Financial Officer

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED OPERATIONS AND DEFICIT

Year ended May 31

	2007	2006
	\$	\$
REVENUE		
Sales	821,024	2,845,341
Cost of sales	874,515	2,972,156
Gross loss	-53,491	-126,815
Expenses		
Administration	880,331	841,737
Selling, marketing and business development	1,266,359	883,461
Legal fees	18,850	155,950
Audit fees	77,500	68,797
Insurance	78,498	82,166
Amortization of property, plant and equipment	24,828	18,518
Patent and trademark maintenance	23,715	16,059
Research and development	99,875	89,880
Interest and bank charges	16,832	6,749
Foreign exchange loss (gain)	67,787	-3,851
	2,554,575	2,159,466
	-2,608,066	-2,286,281
Other revenue (note 13)	5,240	290,214
Interest revenue	562	11,030
Other costs (note 14)	-36,001	-310,096
Loss before income taxes	-2,638,265	-2,295,133
Future income tax recovery (note 12)	195,000	78,400
Net loss	-2,443,265	-2,216,733
Deficit, beginning of year	-16,270,809	-14,054,076
Deficit, end of year	-18,714,074	-16,270,809
Net loss per share - basic and diluted	(0.031)	(0.033)
Weighted average number of common shares	78,443,983	67,418,141

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

THERMAL ENERGY INTERNATIONAL INC

CONSOLIDATED STATEMENT OF CASH FLOWS

Year ended May 31

	2007	2006
	\$	\$
OPERATING ACTIVITIES		
Net loss for the year	-2,443,265	-2,216,733
Add items not involving cash:		
Stock-based compensation charge	377,755	431,827
Amortization of property, plant and equipment	24,828	18,518
Future income taxes	-195,000	-78,400
Write-off of past President loan to acquire shares	151,500	-
Non-monetary compensation charge	13,031	-
Debt settlement with past President	-	-232,305
Changes in non-cash operating working capital		
Accounts receivable	197,914	-395,236
Contracts in progress	85,000	-24,000
Prepays and other assets	-19,117	-34,166
Accounts payable	-437,488	714,997
Accrued liabilities	-8,646	-151,722
Deferred revenue	901,000	-375,000
Due to the past President	-	-50,730
Net cash used in operating activities	-1,352,488	-2,392,950
INVESTING ACTIVITIES		
(Acquisition) disposal of short term investments	-1,020,880	800,263
Additions to property, plant and equipment	-32,901	-42,279
(Increase) decrease in loan receivable	55,500	-55,500
Net cash used in investing activities	-998,281	702,484
FINANCING ACTIVITIES		
Common shares issued (note 9)	2,840,846	1,575,367
Net cash provided by financing activities	2,840,846	1,575,367
Increase (decrease) in cash for the year	490,077	-115,099
Cash, beginning of year	59,119	174,218
Cash, end of year	549,196	59,119
Interest paid	3,242	1,928
Tax impact of renounced expenditures	195,000	78,400
Shareholder loans to acquire shares	7,500	119,305

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1 GOVERNING STATUTES AND NATURE OF OPERATIONS

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

2 GOING CONCERN

The Company incurred losses from operations in the current and prior year.

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 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies are as follows:

Basis of consolidation

The consolidated financial statements of the Company include the accounts of its wholly owned subsidiary, 2003356 Ontario Inc. and Thermal Energy International Corporation incorporated under the laws of the State of Delaware in the United States of America.

Use of estimates

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

Revenue recognition

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

Cash and cash equivalents

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

Short term investments

The Company invests cash surplus to current requirements in money market funds. They are recorded at the lower of cost or market.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Amortization

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

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

Loss per share

The basic loss per share is calculated on the basis of net loss divided by the weighted average number of common shares outstanding during the year. The diluted per share amount is calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options. The treasury stock method assumes that proceeds received from the exercise of the in-the-money stock options are used to repurchase common shares at the prevailing market rate. The diluted loss per share is equal to the basic loss per share because the effect of dilutive stock options described in Note 11 is antidilutive.

Income taxes

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

Research and development costs and government assistance

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

Foreign currency translation

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

Investment tax credits

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

Stock-based compensation

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

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.

4 SHORT TERM INVESTMENTS

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

5 ACCOUNTS RECEIVABLE

	2007	2006
	\$	\$
Trade	377,124	517,914
Other	51,457	108,581
	428,581	626,495

At May 31, 2007, 94% (2006 – 90%) of trade receivables were from one customer.

6 LOANS RECEIVABLE

Loans receivable were \$Nil (2006 - \$55,500 and included an amount of \$37,000 from a director and \$18,500 from an officer). These loans bore no interest.

7 PROPERTY, PLANT AND EQUIPMENT

	2007		2006	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Furniture and fixtures	81,671	62,597	81,671	58,176
Laboratory equipment	46,675	14,183	15,178	6,921
Computers	140,166	133,675	138,761	127,663
Software	12,081	12,081	12,081	12,081
Leasehold improvements	21,401	11,846	21,401	4,712
	301,994	234,382	269,092	209,553
Accumulated amortization	(234,382)		(209,553)	
Net book value	67,612		59,539	

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

8 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.

	2007	2006
	\$	\$
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Transactions with and balances owing to/from directors		
Fees for services	36,750	18,000
Accounts receivable	-	1,635
Loans receivable	-	37,000
Accrued liabilities	18,750	6,750
Common shares issued	-	1,116,667
Flow-through shares issued	293,125	400,000
<hr/>		
Directors share options outstanding at May 31		
Issued	4,000,000	2,300,000
Exercisable	3,233,000	1,975,000
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Transactions with and balances owing to/from officers		
Fees for services	192,000	187,000
Accounts receivable	-	2,955
Loan receivable	7,500	18,500
Accrued liabilities	-	2,667
Common shares issued	125,000	733,000
Flow-through shares issued	143,081	107,422
<hr/>		
Officers share options outstanding at May 31		
Issued	1,993,000	1,043,000
Exercisable	1,434,000	880,500
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Changes to the amounts due to the past President during the year were as follows:		
	2007	2006
	\$	\$
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Balance due to the past President, beginning of year	17,937	300,972
Debt settlement (Note 13)	-	(232,305)
Payments made on behalf of past President	-	(730)
Cash payment to the past President	-	(50,000)
Balance due to the past President, end of year	17,937	17,937

Amounts due to the past President have no fixed repayment terms and are non-interest bearing.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

9 CAPITAL STOCK AND CONTRIBUTED SURPLUS

	2007		2006	
	# 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 1 to 1 basis				
at the rate of 20% of the number originally issued per year.				
Class A Common shares issued				
Balance, beginning of year	74,570,256	14,733,084	63,198,899	12,776,987
Issued in settlement of liabilities	1,160,584	181,393	1,247,432	179,235
Issued for cash, net of flow through share tax benefit (i)	15,137,579	2,645,846	8,573,925	1,377,772
Issued as a result of the exercise of options	50,000	13,000	1,550,000	399,090
	90,918,419	17,573,323	74,570,256	14,733,084
Less: loans outstanding to assist shareholders in purchasing capital stock (ii)		(113,774)		(270,805)
Balance, end of year	90,918,419	17,459,549	74,570,256	14,462,279

(i) In February 2007, the Company renounced expenditures of \$540,000 (2006 \$216,973) from 3,484,334 (2006 2,012,432) flow-through common shares issued during the respective fiscal years. The resulting future income tax recovery of \$195,000 (2006 \$78,400) was charged against capital stock.

In fiscal 2007 and 2006 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.

(ii) A balance of \$46,969 is outstanding on a shareholder loan to the President to purchase shares in fiscal 2006. A loan to an officer of \$7,500 in fiscal 2007 and \$59,305 in fiscal 2006 to other shareholders to assist in the purchase of common shares was extended. 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 74% (114% fiscal 2006) and for both years an expected dividend rate of 0%, risk free interest rate of 3.85% and an expected life of one year.

During the year, the Company entered into 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 1,101,217 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) Activity in share purchase warrants was as follows:

	2007		2006	
	# Warrants	Weighted Average Exercise Price	# Warrants	Weighted Average Exercise Price
		\$		\$
Balance, beginning of period	10,154,896	0.30	12,024,698	0.24
Issued	7,312,162	0.37	1,628,895	0.35
Exercised	-	-	(3,183,334)	0.14
Expired	(2,986,668)	0.25	(315,363)	0.14
Balance, end of period	14,480,390	0.35	10,154,896	0.30

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

Warrants Outstanding	Exercise Price \$	Expiry Date
3,333,666	0.35	To June 3, 2007
3,867,895	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>14,480,390</u>		

Contributed surplus

	2007	2006
	\$	\$
Balance, beginning of year	1,509,232	1,237,995
Stock-based compensation	377,755	431,827
	1,886,987	1,669,822
Fair-value of options exercised and transferred to capital stock	5,500	160,590
Balance, end of year	1,881,487	1,509,232

10 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	106,000
2009	34,300
2010	1,900
Total	142,200

11 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 2007 and 2006 had vesting periods ranging from four to twelve months.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(a) Activity in stock options was as follows:

	2007		2006	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise price \$
Outstanding, beginning of year	4,718,714	0.17	7,043,714	0.16
Granted	4,475,000	0.17	850,000	0.23
Exercised	(50,000)	0.15	(1,550,000)	0.15
Cancelled	(250,000)	0.19	(975,000)	0.18
Expired	(525,714)	0.16	(650,000)	0.15
Outstanding, end of year	8,368,000	0.17	4,718,714	0.17
Number of options exercisable as at May 31	6,126,000		4,024,964	

Options exercised during the year were as follows:

	2007		2006	
	# shares	\$	# shares	\$
Employees	50,000	7,500	1,025,000	169,500
Directors	-	-	325,000	49,000
Consultants	-	-	200,000	20,000
	50,000	7,500	1,550,000	238,500

In 2007 and 2006, all options were exercised for cash.

(b) The following options are outstanding and/or exercisable at May 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
1,000,000	1,000,000	0.10	February 1, 2008
500,000	500,000	0.12	February 1, 2008
150,000	150,000	0.24	March 1, 2008
900,000	900,000	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	0.18	September 7, 2009
3,500,000	1,883,000	0.16	December 20, 2009
625,000		0.20	March 15, 2010
8,368,000	6,126,000		

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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:

	2007	2006
Weighted average assumptions:		
Expected dividend	0.00%	0.00%
Expected volatility	90%	111%
Risk-free interest rate	3.85%	3.85%
Expected option life in years	2.4	2.4
Fair value	\$0.16	\$0.14

Stock-based compensation expense in fiscal 2007 includes an amount of \$20,505 for options granted to consultants (2006- \$6,400). Employee stock-based compensation expense is \$357,250 (2006 - \$425,427).

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12 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:

	2007	2006
	\$	\$
Loss before income taxes	(2,638,265)	(2,295,133)
Income taxes calculated using the combined federal and provincial income tax rate in Canada of 36.12% (2006 – 36.12%)	(952,900)	(829,000)
Stock-based compensation	136,400	156,000
Other	3,800	50,100
Effect of changes in valuation allowance	617,700	544,500
Future income tax provision (recovery)	(195,000)	(78,400)

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

	2007	2006
	\$	\$
Future income tax assets		
Non-capital losses	2,289,300	2,409,900
Intangible assets	989,300	989,300
Property, plant and equipment	99,700	90,700
Share issue costs	800	3,500
	3,379,100	3,493,400
Valuation allowance	(3,379,100)	(3,493,400)
Net future income tax asset	-	-

The Company has financed part of the start-up phase of renewable energy and energy conservation projects through the issuance of flow-through shares. Under the terms of the flow-through share agreements, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregoing tax benefits to the Company, the carrying value of the shares issued is reduced by the tax effect of the tax benefits renounced to subscribers. The tax effect of the renouncement is recognized on the date the Company files the renouncement documents with the tax authorities to renounce the tax credits associated with the expenditures, provided there is reasonable assurance that the expenditures will be made. During fiscal 2007, the Company renounced approximately \$540,000 (2006 - \$217,000) of expenditures. At May 31, 2007 and 2006 there are no expenditures that are required to be incurred before December 31, 2007. Participation in this program is subject to verification by tax authorities with respect to the nature and timing of expenditures.

As at May 31, 2007, 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
	\$
2009	1,086,000
2010	1,395,000
2014	355,000
2015	533,000
2026	1,276,000
2027	1,693,000
Total	6,338,000

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

13 OTHER REVENUE

	2007	2006
	\$	\$
Gain on write-off of convertible debt, past President	-	329,823
Gain on write-off of commissions due to past President	-	36,548
Write-off of receivable from past President	-	(134,066)
Cancellation of convertible debentures	-	25,529
Gain on extinguishment of a liability	5,240	32,380
	5,240	290,214

In fiscal 2007, other revenue resulted from a gain on the extinguishment of a liability. In fiscal 2006, after review by the past President, creditors and the Company, in June 2005, an agreement was reached to reduce the resulting obligations to the past President.

14 OTHER COSTS

In fiscal 2007, costs incurred to remedy a design deficiency for a project were charged to other costs in the amount of \$36,001 (2006 - \$310,096).

15 SEGMENTED INFORMATION

The Corporation operates in one operating segment – energy conservation and environmental compliance (air) within North America. 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.

Two unaffiliated customers accounted for 100% of sales in 2007 and in 2006. The Company continues to work aggressively with other partners and potential new partners to attract new customers.

16 FINANCIAL INSTRUMENTS

The following methods and assumptions were used to determine the estimated fair value of each class of financial instruments.

Short-term financial instruments

The fair value of the short-term financial assets and liabilities approximates their carrying amount given that they will mature shortly.

Loans receivable

The fair value of loans receivable, all of which have been granted to directors and officers, has not been determined because it is practically impossible to find financial instruments on the market having substantially the same economic characteristics.

Foreign exchange risk

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 May 31, 2007, cash, short term investments, accounts receivable and accounts payable denominated in U.S. dollars totalled US\$244,694, US\$300,000, US\$343,075 and US\$29,390 respectively (US\$1,852, US\$Nil, US\$Nil and US\$17,007 as at May 31, 2006).

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 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.

18 COMPARATIVE AMOUNTS

Certain 2006 amounts have been reclassified to conform with the current period's presentation. This included stock-based compensation, previously presented separately in the Consolidated Operations and Deficit statement and which has now been included in the expenses to which it relates. In the year ended May 31, 2007, \$80,411 (2006 - \$285,387) was reclassified to Administration and \$297,344 (2006 - \$146,440) to Selling, marketing and business development.