



An Innovative Technology Company Providing
Custom Energy and Emission Reduction Solutions

Annual Report to Shareholders

Fiscal Year End
May 31, 2008



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.

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President's Message to Shareholders

Dear Shareholders:

This past fiscal year saw Thermal Energy achieve record revenues and most importantly, validation of our innovative new THERMAL-AUD™ offering which we see as providing a solid future and predictable revenues for the Company and our shareholders.

These are but two elements of a very busy year for Thermal Energy's management and staff as we continue to grow the Company and build key customer relationships at the Fortune 500 and Global 500 level. While this takes time, considerable effort and forward investment, management is convinced this is the right course. We are doing this at a time when major industry and corporations are finally taking note on a strategic and corporate basis in the C-level suite, that energy efficiency and sustainability is not just good for business - it is good business. Our goal is to engage these corporate "champions" and drive the implementation of our solutions down across the entire corporate structure. For example, it may take a longer time to become a preferred supplier to a corporation, but once that status is achieved, multiple, replicable orders start to flow at an accelerated pace.



Thermal Energy President and CEO Tim Angus (right) and Tim Gardner, Managing Director, GEM, (left) show steam traps from the GEM® Condensate Return System at the GEM offices in Bristol U.K. Thermal Energy completed its acquisition of GEM just after the end of Fiscal Year 2008

To that end, we completed our first contract for a Global 500 food manufacturer at one of their U.S. production facilities. The \$1.4 million energy recovery project using our FLU-ACE® waste heat recovery technology has reduced the customer's fuel costs and greenhouse emission by about 15%. A significant aspect to this project was Thermal Energy's ability to identify those large savings on top of approximately 15% of savings which had been achieved by the client implementing previous energy saving measures.

During the year, Thermal Energy conducted detailed engineering studies for two U.S. pulp and paper projects. At year's end, we were engaged in contract negotiations for those projects. One is a multi-million dollar FLU-ACE® capital project and the other is a \$20 million, eight-year, energy services program which would utilize multiple FLU-ACE® systems.

THERMAL-AUD™ (Alternate Utility Delivery)

In FY 2008, our THERMAL-AUD™ offering led to the first of these relationships with Fraser Papers and a very successful project at the Thurso Paper Mill in Thurso, Quebec. This project is worth up to \$3.75 million over six years and utilizes FLU-ACE® technology to recover waste heat. Its success has opened the doors to several much larger opportunities across the Fraser Papers' corporate landscape and with other companies in Canada and the U.S.

The THERMAL-AUD™ Alternate Utility Delivery Program was designed and introduced last fiscal year. This program provides an alternative to capital purchases of our solutions. THERMAL-AUD™ lets customers meet corporate energy cost and emission reduction targets without investing capital funds.

Instead, Thermal Energy, through its subsidiary ForEverGreen Energy Services Inc., will install its solutions and sell the output to the customer on a long-term green energy services contract. For instance, the waste heat recovered from a FLU-ACE® waste heat recovery system is sold to the customer at an attractive price compared to the fossil fuel it is displacing. It would allow us to sell the dried biomass processed through a DRY-REX™ low temperature biomass system as high efficiency biofuel at a discount to the price of the fossil fuel it replaces. This provides customers immediate energy and cost savings from Day One of operation, reduced greenhouse gas and other emissions, stable energy pricing and virtually no risk. In return, Thermal Energy receives a recurring revenue

stream for the duration of the energy contract period, an asset base and other benefits such as monetizing carbon credits.

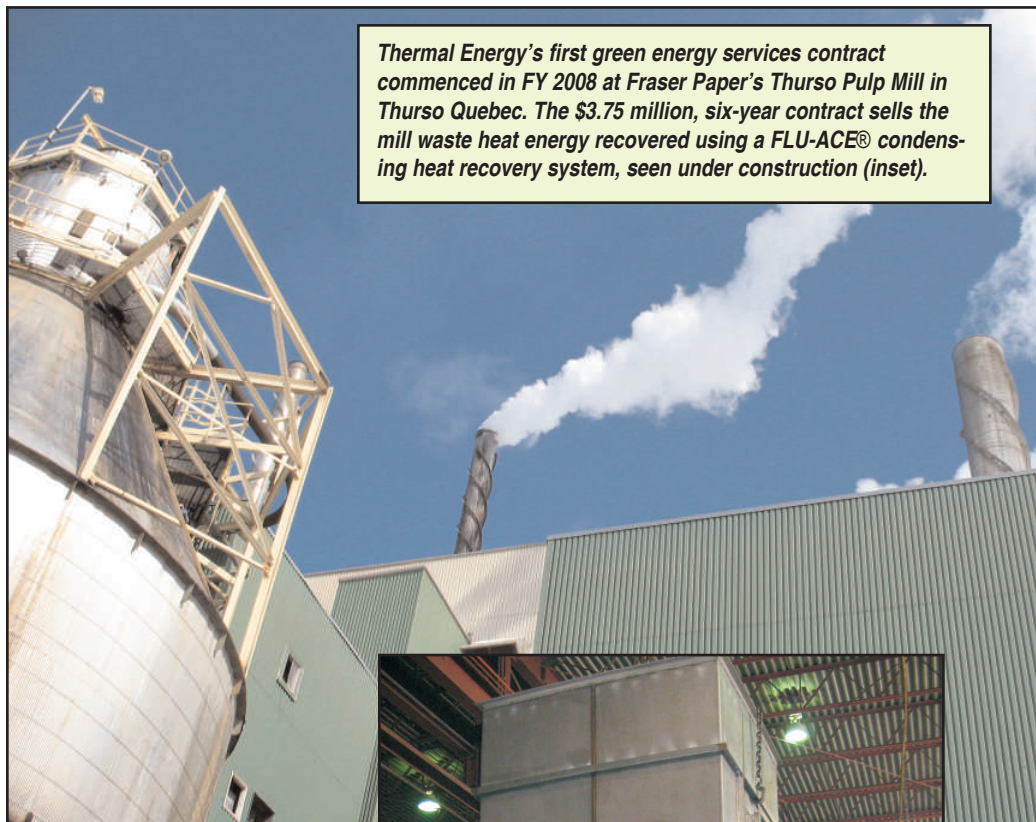
Financial institutions and investors continued to show their support for Thermal Energy's business strategy in 2008. We obtained our first institutional line of credit for \$2.5 million from TD Bank during the year which enabled us to move rapidly with the Thurso project. We also completed a private placement during the year with gross proceeds of just under \$1 million to assist with operations, sales and marketing.

GEM Acquisition

FY2008 also set the stage for a major acquisition and expansion into Europe through our relationship with Gardner Energy Management (GEM) of Bristol, U.K. Thermal Energy has been enjoying success with positioning the revolutionary GEM Condensate Return System in North America and China. The GEM steam traps are a permanent replacement solution to traditional mechanical steam traps which have changed little since the Industrial Revolution. With sales in petrochemical, pulp and paper and other sectors during the year, Thermal Energy realized there were greater synergies to be had beyond a supplier relationship and management moved quickly to acquire GEM, which has an existing client base with installations at facilities of numerous Global 500 companies in key energy intensive sectors.

By the end of the fiscal year, management had entered into an agreement to buy GEM for a base price of £2.7 million (approximately \$5.4 million CAD) and an amount of £1.3 million (approximately \$2.6 million CAD) conditional on the future performance of the GEM business line over the next three years.

This set the stage for management to initiate the largest private placement in Thermal Energy's history, a \$15 million transaction conducted with leading clean tech funds in Toronto, New York and London, which was concluded shortly after the close of the fiscal year. While the results of this financing are not included in our FY 2008 financial statements, they provided the cash to complete the GEM acquisition, funding for assets to be used in THERMAL-AUD™ projects, funds for research and development, and funds for operational activities including expanded sales and marketing efforts. The financing also resulted in a 40% institutional



Thermal Energy's first green energy services contract commenced in FY 2008 at Fraser Paper's Thurso Pulp Mill in Thurso Quebec. The \$3.75 million, six-year contract sells the mill waste heat energy recovered using a FLU-ACE® condensing heat recovery system, seen under construction (inset).

China

Thermal Energy has several initiatives under way in China as a result of new and ongoing strategic initiatives. First, we continued to develop the scope of work and parameters for our research and development joint venture with the South China University of Technology (SCUT) for our THERMALONOX™ technology to reduce nitrogen oxides (NOx) from coal-fired power plants and other industrial sources.

We also established a joint venture company as majority owner in Guangzhou, China, to market our energy saving solutions. Thermal Energy International (Guangzhou) Ltd. has achieved a number of initial sales of GEM® steam traps and we look forward to increased sales from this operation which currently has four staff involved in sales and marketing activities.

During the year, we also entered into a new energy saving alliance to target industry in China. The Asia Energy Efficiency Alliance is led by Honeywell Building Solutions and Asia Clean Capital Ltd. It also includes Solar Turbines, a Caterpillar company. The Alliance intends to position a full suite of

energy efficiency solutions as well as attractive financing alternatives to the textile, pulp and paper and other energy intensive industries in China.

The Road Ahead

In FY2008, we achieved a slight reduction in our net loss and will continue to work on improving cost controls and expenditures in FY 2009. However, management recognizes that business fundamentals for any company in a growth and expansion mode, require it to spend ahead of the revenue curve to develop these markets. Thermal Energy will continue to make these investments on a strategic basis where there is a reasonable expectation of a return on these investments in the mid to long-term.

We also understand that expenditures have visibility as losses due to our current revenue levels. As our revenues grow in FY 2009 we expect to deliver significant bottom line improvements. One of the challenges Thermal Energy has faced during the past few years has been one of having an effective sales and marketing force. Limited resources through this period meant the Company has had to rely on a sales network that mostly involved representatives and agents instead of direct sales staff. Unfortunately, these representatives are not dedicated to Thermal Energy on a 100% basis. While we continue to enjoy an excellent working relationship with Johnson Controls Inc., which has produced significant revenues for Thermal Energy, again, our solutions comprise a very small part of their portfolio to offer their customer base.

investor base, providing good stability and support.

The GEM acquisition also provides Thermal Energy an established sales base in Europe through which to deploy our core solutions. With the completion of this transaction in Q1 FY2009, Thermal Energy will devote the appropriate resources to ensuring the GEM sales team is well equipped to approach existing customers with added-value solutions and potential new customers with a full suite of energy saving solutions.



DRY-REX™ Lab

Following our acquisition of the DRY-REX™ low temperature biomass drying technology in FY 2007, Thermal Energy continues to market this solution to key targeted industrial sectors. This solution has generated considerable interest and we are working diligently toward securing new customers for this technology.

This year we established a DRY-REX™ test laboratory in Chilliwack, B.C. under the guidance of Thermal Energy's Chief Scientist Dr. Raymond Belanger. This lab has been quite helpful in marketing a large scale solution where prospective clients need to see proof of efficacy for drying their waste in order to make an informed decision. In its first few months, the lab has conducted testing for a number of prospective customers on various waste products. We are continuing to work with these customers to develop DRY-REX™ solutions for them in FY 2009.

With increased resources through FY 2008 and a significant cash position due to the \$15 million financing completed in the first quarter of FY2009, Thermal Energy is refocusing its sales and marketing efforts and has commenced development of a dedicated, direct sales team strategically targeting key industri-

al sectors and geographies in North America. This will complement the newly acquired sales team across Europe through the GEM acquisition.

The first step in this process was the hiring of Anthony Pugliese as Vice President, Sales, who is devoted 100% to developing a new sales direct sales organization and closing on advanced proposals from our pipeline of sales opportunity. Anthony is also working on furthering a number of relationships at the corporate level in line with our sales strategy.

In addition to Anthony, we have hired a business development manager for GEM® sales in North America, new sales



One of Thermal Energy's first customers in China is the Lee & Man Paper Co. in Guangdong China which is now using GEM steam traps. An employee with Thermal Energy International (Guangzhou) Ltd., conducts a steam trap test at Lee & Man (inset).

representatives in Quebec and Alberta (to target the oil sands), and two sales representatives in the U.S., one for the southern U.S. based in Florida and another for the mid-Atlantic market based in Philadelphia.

We will continue to add experienced sales personnel for all our solutions in FY 2009 as we establish a high-performance sales team to drive revenues and ultimately achieve our goal of profitability.

I would like to thank all our employees for their hard work this past year and ask them to join me in welcoming our new colleagues from GEM into the Thermal Energy family. Last but not least, I want to again thank our shareholders, both new and old, who share our vision. I look forward to sharing much good news with you in the coming months.

Sincerely



Tim Angus
President and CEO

Thermal Energy Highlights Fiscal 2008

June 15, 2007 - Appointed 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 health-care and public sector markets. Mr. Pugliese was previously Account Manager, Healthcare Solutions with Johnson Controls, Inc., in eastern Canada, and has an extensive background in financial services;

June 21, 2007 - 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;

August 15, 2007 - Established ForeverGreen Energy Inc., a wholly-owned energy services subsidiary. ForEverGreen signed a \$3.75 million, six-year green energy services agreement with Fraser Papers Thurso Pulp Mill on August 27, 2008, using the THERMAL-AUD™ Alternate Utility Delivery Program;

October 29, 2007 - Completed the first waste heat recovery project in the U.S., valued at \$1.4 million;

November 28, 2007 - Became majority owner through its wholly-owned subsidiary (Thermal Energy International (Guangzhou) Ltd.) in a joint venture with Oriental-Unicorn Sales and Marketing Co., of Guangzhou, China and E5 Enterprises LLC, of Markham, Ontario. Oriental-Unicorn was instrumental in the Company's first sale of GEM® steam traps to Lee & Man Paper Co.;

December 13, 2007 - Secured a five-year, \$2.5 million line of credit with the Toronto-Dominion Bank to facilitate the Company's co-investment in assets such as FLU-ACE® and DRY-REX™ systems using its Thermal-AUD™ Program;

January 21, 2008 - Closed a non-brokered private placement with gross proceeds of \$999,000 to support on-going sales and marketing;

March 27, 2008 - Joined the Asia Energy Energy Alliance led by Honeywell (China) to provide energy saving solutions and project financing for China's pulp and paper and other energy-intensive industries;

April 7, 2008 - Entered into an agreement to acquire Bristol based Gardner Energy Management Ltd. The transaction with a base price of approximately \$5.4 million CAD and an amount of approximately \$2.6 million CAD payable on an earn-out basis over a three-year period based on sales of the GEM® product line to a new major customer, subsequently closed in the first quarter of Fiscal 2009;

April 23, 2008 - Commenced the first phase of work (detailed design and engineering) for a major FLU-ACE® energy recovery system at a fine paper mill in the north eastern U.S.



asia energy efficiency alliance






With the support of:   

Financial Information

MANAGEMENT'S DISCUSSION & ANALYSIS - 2008

Overview

This discussion explains the material changes in the Company's financial condition and results of operations for the fiscal year ended May 31, 2008 (or FY 2008), and compares the FY 2008 financial results to the previous year ended May 31, 2007 (or FY 2007). 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 and bioenergy 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. FLU-ACE®, THERMALONOX™, THERMALOZOMAX™, GEM® and DRY-REX™ 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 USA, Europe ("EU"), and Canada 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 proprietary air compliance and waste heat recovery technologies and solutions, designed specifically to cost-effectively meet or exceed both the current and future anticipated US and EU air pollution emissions regulations.

Thermal Energy is well positioned to provide the US, EU, and Canada with the best available products, technologies, and solutions to most economically meet both the medium-term and longer-term air compliance and energy conservation objectives. In addition to having cost effective environmental compliance and energy conservation solutions, Thermal Energy continues to grow and work through strategic alliances, cooperative partnerships, and synergistic sales development associations with US and Canadian companies in order to sell, market, and implement retrofit solutions in North America. Recently, the Corporation established new strategic alliances and cooperative relationships with companies in China to further improve the Corporation's competitive access to global markets.

Through unique energy conservation and self-financing solutions, Thermal

Energy is economically assisting in meeting Canadian, and soon US, and EU environment protection policies, strategies and goals to achieve cost effective environmental compliance.

Energy Conservation and Environmental Compliance Solutions Business

Thermal'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 Corporation 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 Company's 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 processes, 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: Offered by Thermal Energy under exclusive licence in Canada, China and key U.S. markets since 2006, 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. This is a process for which patent applications have been filed. THERMALONOX™ utilizes phosphorus to create a chemical reaction to remove the NOx. Research is under way at the Company's laboratory facilities in

Financial Information (Cont'd)

Cranbrook, B.C. where initial tests show a better than 98% rate of NOx reduction. Current best available commercial technology known as Selective Catalytic Reduction (SCR) and Selective Non-Catalytic Reduction (SNCR) is considered problematic, costly and has a lower rate of NOx removal that is projected for THERMALONox™. 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™.

Throughout FY 2008 the Corporation 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.

The Thermal Energy mission statement can be summarized as follows: to increase sales through existing (JCI) customer relationships by targeting energy solutions sales opportunities which will result in a faster sales cycle for both companies, while targeting niche industrial and commercial market sectors where Thermal Energy solutions provides a strong competitive advantage.

Although JCI accounted for nearly all of the sales in FY 2004, FY 2005, FY 2006, FY 2007 and approximately 50% of all sales in FY 2008, the Corporation continues to work aggressively with other new and potential partners to attract new customers. An example of such a new arrangement was the creation of a joint venture named Thermal Energy International (Guangzhou) Ltd in China with Oriental-Unicorn Sales and Marketing Company, Ltd. located in Guangzhou, China and E5 Enterprises, LLC located in Toronto, Canada in Q2 FY 2008 to deploy the Corporation's energy recovery products and solutions in key Chinese markets. Inc. As a result, management is confident that the Corporation would continue in the absence of contracts with JCI.

The Corporation completed its first recovery/energy cost reduction project at a major food and beverage facility in the U.S. for an estimated value in excess of \$1.4 million. Its second commercial contract in the U.S. market which was also the first to use both the Company's FLU-ACE® waste heat recovery solutions and its new state-of-the-art GEM® Condensate Return System was approximately 95% complete at year end. Throughout the year the Corporation continued to receive small purchase orders to install its newly acquired energy saving, GEM® condensate return technology at a Global 500 company's facility in the U.S. as well as purchase orders for trial testing of the GEM® condensate return technology at various industrial sites throughout Canada and China.

In addition, the Corporation through its wholly-owned subsidiary, ForEverGreen Energy Inc. (FEI) implemented a contract valued at \$2,209,842 Fraser Paper Inc.'s Thurso mill. FEI began monthly invoicing to the customer in March, 2008 for the supply of green energy. In addition, the Corporation completed a feasibility study for a fine paper mill in the north eastern United States for the installation of a FLU-ACE® condensing heat recovery system to recover waste heat from the mill's Recovery Boiler dissolving tank exhaust. The value of the first of a two phase contract was US\$130,000.

In addition the Corporation successfully diversified its business development model using its THERMAL-AUD program to initiate direct sales of proven FLU-ACE® and DRY-REX® solutions to established Fortune 500 customers, while continuing to develop new non-exclusive strategic alliances under a new, more cooperative, joint venture alliance model.

During FY 2008, the Corporation cooperated with JCI to develop and propose many industrial and institutional FLU-ACE® Energy Recovery Solutions to establish a growing multimillion dollar potential sales pipeline in Canada and the US. While the Corporation was successful in generating \$4,926,208 in sales

during FY 2008, it also developed a large project in excess of \$20M with a North American integrated paper company located in north eastern United States which led to the signing of a Letter of Intent on June 2, 2008. Notwithstanding the final value of this project which is currently being finalized, there is approximately \$524,000 in carry-forward revenues from the Fraser-Thurso project and the Phillips project in FY 2009. However, the potential sales pipeline of qualified bids significantly increased to an amount in excess of \$200,000,000 and these will carry-over to FY 2009.

During FY 2008 the Corporation remained committed to the future product development and commercialization of the patented THERMALONox™ technology with the design and procurement of equipment for the further testing of its THERMALONox™ solution, planned for Q2 and Q3 FY 2009. Over the past year, the Corporation's chief scientist, Dr. Raymond Belanger, continued to conduct further laboratory testing of ozone generation, which is fundamental to the chemical reaction required to remove NOx from flue gas streams and one of several components required for a complete emission reduction solution.

Additionally, the Corporation continued to evaluate potential partners in the medium and large electric utility market who could sponsor a large scale demonstration of the technology now that it has successfully completed its laboratory testing.

Finally it reached an agreement with SCUT, with Chinese government backing, on the division of work related to the joint research and developmental testing of industrial applications for the Company's THERMALONox™ technology on a coal-fired power plant slip stream in Guangdong province, which has been indentified by SCUT as a suitable test site.

During the early part of FY 2007 the Corporation expanded its suite of energy savings solutions by acquiring the award-winning, patented DRY-REX™ bioenergy technology from Mabarex Inc., of Montreal (www.mabarex.com). With this agreement, the Corporation took immediate ownership of the exclusive worldwide license to the DRY-REX™ technology and the transfer of all intellectual property (patent) rights on an earn-out basis over five years. While no contracts have been realized to date, there has been favourable reaction to this technology that has resulted in the submission of several proposals to potential customers. The Corporation's Chilliwack laboratory was converted to test for the drying of sludge materials that can abet in the development of a DRY-REX® solution.

The total value of the Mabarex technology acquisition was \$3.25 million. This included the issuance of 500,000 common shares of the Corporation at a deemed price of \$0.16 per share. The remainder of the acquisition price is to be retired through royalty payments on the Corporation's sales of DRY-REX™ solutions.

The Corporation was successful in financing its working capital requirements to support its business development efforts, by raising capital through the completion of a non-brokered private placement. The private placement with gross proceeds of \$999,000 closed on January 21, 2008. The financing consisted of the issuance of 1,455,000 Units at \$0.30 per unit with each unit comprising one common share and one non-transferable share purchase warrant entitling the holder to acquire one additional common share at any time within two years of issuance at a price of \$0.50 per share. It also consisted of an issuance of 1,875,000 flow-through shares at a deemed price of \$0.30 per share.

The Corporation also secured a five-year, \$2.5M line of credit with the Toronto Dominion Bank to finance its THERMAL-AUD Program, through its wholly-owned subsidiary, FEI.

Financial Information (Cont'd)

The Corporation incurred a net loss during the year of \$2,372,508 compared to \$2,443,265 during the previous year and has an accumulated deficit at year-end of \$21,086,582. 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 and will continue to improve by achieving or exceeding targeted gross margins. In addition the Company anticipates further funds will become available in the approximate amount of \$3,000,000 from the exercising of options and warrants later in the second half of FY 2009. Together, this will satisfy the planned expansion of its R&D work in China on its new THERMALONOX™ technology solution and significantly expand sales and marketing capabilities throughout North America and China.

Revenues and Gross Profits

Revenues were \$4,926,208 in FY 2008 compared to \$821,024 in FY 2007. Revenues increased significantly in FY 2008 compared to FY 2007 due to more secured and significantly larger sized contracts from the previous year, primarily from its completed contract at Fraser's Thurso mill and two US contracts at Kelloggs and Phillips Lighting.

The gross profit of \$608,024 in FY 2008 improved substantially from a gross loss of \$53,491 in FY 2007. These results expressed as a percentage of sales were 12.34% in FY 2008 compared with (6.51%) in FY 2007.

The current year profit was due to the completion of the Fraser Thurso project ahead of schedule and below budget, despite the combination of increased cost over-runs and foreign exchange losses of \$380,163 at the Phillips project and warranty related costs of \$122,793 incurred at the Valley Regional Hospital, associated with the remedy of previous design deficiencies, at Camco and Minas Basin. Additionally, \$25,000 was accrued as a warranty provision.

Expenses

Administration expenses in FY 2008 were \$1,228,984 compared with \$880,331 in FY 2007. The increase in costs was due mainly to increases in stock-based compensation of \$262,000, directors' fees (full year in FY 2008 as opposed to partial in the previous year) of \$30,000, combined UIC, EHT and WSIB of \$38,000, consultant's due diligence costs to acquire GEM Ltd of \$50,000 and a provision of \$30,000 for doubtful accounts.

Selling, marketing and business development expenses were \$1,314,208 in FY 2008 compared to \$1,266,359 in FY 2007. The major changes were increases in sales salaries of \$92,500, commissions of \$109,800, business development pursuing FLU-ACE heat recovery work and GEM sales in China of \$66,000 and \$72,000 respectively, and business development pursuing GEM sales in Canada of \$63,000. These were offset by declines of \$144,400 in stock-based compensation and of \$230,700 in other business development costs.

Legal expenses in FY 2008 were \$331,836, a significant increase compared to the amount of \$18,850 incurred in FY 2007. Approximately \$93,500, represents the increase in preparatory work for discoveries related to the litigation by the past President and CEO against the Company and \$120,000 represents partial legal costs by U.K. lawyers in assisting with the acquisition of GEM Ltd.

Audit expenses in FY 2008 were \$72,839 compared to \$77,500 in FY 2007.

Insurance expenses increased significantly to \$127,993 in FY 2008 compared with \$78,498 in FY 2007 due to new premiums of \$69,500 for professional liability (errors & omissions).

Patent and trademark maintenance costs were \$13,587 in FY 2008 compared to \$23,715 in FY 2007 with respect to countries where patents have been granted. Patent and trademark maintenance costs are expensed as incurred. The decrease in costs year over year was due to a lessening of reporting requirements pending the testing of the Company's THERMALONOX™ technology planned for the second quarter of FY 2009.

Research and Development costs decreased slightly in FY 2008 to \$87,572 compared to \$99,875 in FY 2007 as a result of completion of the laboratory testing program together with a lessening of consumable costs associated with the testing.

Amortization of property, plant and equipment was \$31,314 in FY 2008 compared to \$24,828 in FY 2007. The increased costs were due primarily to the amortization of new equipment associated with the R&D laboratory in the Company's offices in Chilliwack, B.C. and new computer equipment in the Company's head office.

Other revenues

Other revenue was \$Nil in FY 2008 compared with \$5,240 in FY 2007.

Interest revenue

Interest revenue was \$32,098 in FY 2008 compared to \$562 in FY 2007 because of increased balances in investment accounts.

Finance revenue

The Fraser Paper contract in Thurso, Quebec, which was delivered through the THERMAL-AUD program, was accounted for as a sales-type lease and, accordingly finance revenue of \$56,201 was recognized in relation with this contract.

Other costs

Other costs were \$Nil in FY 2008 compared to \$36,001 in FY 2007.

Net Loss

Net Loss was \$2,372,508 in FY 2008 compared to a net loss of \$2,443,265 in FY 2007. Contributing factors resulting in the loss in 2008 were the 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 and legal costs referred to earlier, and insufficient sales volume to cover the current level of fixed costs of the Company required 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.

Liquidity

The working capital deficiency of \$2,093,061 at the end of FY 2008 increased significantly compared to the working capital of \$559,350 at the end of FY 2007. Current assets decreased by \$383,522 to \$1,680,029. The major changes in current assets were decreases in cash of \$464,479 and short-term investments of \$468,107 offset to a lesser extent by increases of \$198,990 in accounts receivable, \$152,000 in contracts in progress and the current portion of the net investment lease of \$227,034. Current liabilities increased by \$2,268,889 to \$3,773,090. The changes were the result of increases in the bank loan of \$908,667, accounts payable of \$1,673,619 and accrued liabilities of \$301,695, partly offset by a decrease in deferred revenue of \$615,092.

Financial Information (Cont'd)

Other cash requirements in FY 2008 were met by the issue of common shares with a value of \$999,000 from private placements. This was in excess of current requirements and \$552,773 was invested in short-term securities. Cash requirements continued to be adversely affected by insufficient sales volume to cover the current level of fixed and variable costs.

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. In addition, the Company has completed one (1) non-brokered private placement in the third quarter of FY 2008 with gross proceeds of \$999,000.

Additionally, during the fourth quarter of FY 2008 the Company actively explored opportunities to further structure a multi-million dollar financing of its new Business Plan, which involved the acquisition of GEM Ltd., of Bristol, U.K. This culminated with the Company's successful completion of a brokered private placement at the beginning of Q1 FY 2009 with gross proceeds of \$15,000,000, which would be used for completing the acquisition of GEM, to expand sales and marketing efforts in North America, Europe and China, to assist in project financing and for R&D testing activities of THERMALONOX™ in China.

Related Party Transactions

In FY 2008 Directors were paid fees for services of \$48,750 and Officers were paid \$188,000. 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 GEM acquisition.

2,366,667 common shares were issued to Directors and 1,843,000 shares were issued to Officers in 2008.

Options outstanding for Directors as at May 31, 2008 were 3,500,000 of which 2,461,000 were exercisable. There were 37,500 warrants outstanding for Directors.

Loans to enable the exercise of options in the amount of \$265,000 for Directors and \$312,300 for Officers were outstanding at May 31, 2008.

Segmented Information

In FY2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America 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 two retrofit technology lines - waste energy recovery solutions and air pollution control solutions. In FY2008 revenue was 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.

Prior to fiscal 2008, customers financed these projects entirely from their own resources and accordingly, the Company operated in only one segment. However in 2008 the Company introduced its Thermal-AUD™ product whereby it finances the project, recovers and obtains a return on its investment by entering in an energy purchase agreement with its customer. Construction of the first Thermal-AUD™ project was completed in late fiscal 2008. This gave rise to two reportable segments which are detailed below:

	May 31, 2008	
	Customer financed contracts and other	Thermal-AUD™ contract
	\$	\$
Revenue from external customers	2,716,365	2,209,842
Inter-segment revenues	19,111	-
Interest and finance revenue	32,098	56,201

	May 31, 2008	
	Customer financed contracts and other	Thermal-AUD™ contract
	\$	\$
Interest expense and bank charges	13,503	6,914
Stock-based compensation charge	495,786	-
Amortization of capital assets	31,314	-
Segment loss (profit)	2,391,014	(18,506)
Segment assets	2,755,526	2,225,562
Expenditures for capital assets	28,768	-

	May 31, 2008	
	\$	
Reconciliation to financial statements		
Revenues		
Total revenues for reporting segments	4,945,319	
Elimination of inter-segment revenues	(19,111)	
Total company revenues	4,926,208	
Loss		
Total loss for reported segments	2,572,508	
Income tax recovery	(200,000)	
Net loss	2,372,508	
Assets		
Total assets for reported segments	4,981,088	
Elimination of inter-segment receivables	(1,287,087)	
Total assets	3,694,001	

Financial Information (Cont'd)

Geographic Segments

	May 31, 2008	
	Revenues \$	Capital Assets \$
Canada	2,382,444	2,013,972
United States	2,507,137	-
China	36,627	-
Total	4,926,208	2,013,972

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, 2006, May 31, 2007 and May 31, 2008

	2006 \$	2007 \$	2008 \$
Sales	2,845,341	821,024	4,926,208
Net loss	(2,216,733)	(2,443,265)	(2,372,508)
Net loss per share - basic and diluted	(0.033)	(0.031)	(0.025)
Total assets	931,430	2,131,163	3,694,001

The earned revenue from sales in FY 2006, FY 2007 and FY 2008 are inconsistent in magnitude. In FY 2007, while secured sales increased to approximately \$3.9 million year-over-year because of long delays in the awarding of two contracts, the earned revenue from sales fell significantly.

The net losses in FY 2006 were partly due to the extra cost over-runs of the Camco project, the costs to remedy design flaws at the Valley Regional Hospital and Stratford General Hospital projects and the litigation costs to defend against the past President.

The net losses further increased in FY 2007 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 variations in assets from FY 2006 through to FY 2008 were affected primarily by an investment of \$800,263 in short term investments in FY 2005 following

the closing of a private placement in the amount of \$1,100,100 late in the fourth quarter of FY 2005. This investment was drawn down in FY 2006 to meet cash requirements. A further closing of a private placement in the amount of \$734,900 which was drawn down in FY 2006 was followed with 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.

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, 2008, 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 finance and complete the development and commercialization of its patented THERMALONOX™ technology at year end. However, with the successful completion of its brokered private placement in Q1 FY 2009, the Company began the design work in earnest to be in a position to test the THERMALONOX™ patented technology by Q2-Q3 FY 2009. The Cost Effective Energy Conservation and Environmental Compliance Solutions sales through the close working relationship with JCI 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 sales quicker 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; and,
- The ability to control costs and achieve a positive gross margin on projects.

Financial Information (Cont'd)

Management's addressing of the risks:

The management of the Company realizes that the increased operating losses in FY 2008, while displaying a consistent pattern of losses as in previous years were primarily due to the unexpected cost over-runs with the Phillips project (using non-core Company technologies), increase in warranty related costs on three previously completed projects and increase spending in selling and marketing of its product lines in China. Additionally, while the sales funnel increased significantly year-over-year it demonstrates the Company's inability to close the "deal" in a timely fashion and the need to improve its efforts to shorten the sales cycle.

With the addition of a new Vice President of Sales in FY 2008 to fully focus on sales and marketing and with new proven sales personnel to be added in Q1-Q2 FY 2009, the Company believes that it will be more productive in future quarters of FY 2009 in its pursuit and closing of sales opportunities.

Management believes that it can continue to grow sales by working closely with JCI as evidenced by the two recently awarded contracts to perform work for its clients in the U.S. In addition there are numerous projects that it is presently jointly pursuing with JCI both in Canada and the U.S and abroad.

In addition management has signed an agreement with SCUT, with Chinese government backing, to jointly research and develop industrial applications for the Company's THERMALONOX™ nitrogen oxides removal technology. The R&D program envisions demonstrating THERMALONOX™ on a coal-fired power plant slip stream in Guangdong province which has been tentatively identified by SCUT as a suitable test site. The Company believes that this cooperative partnership could help to grow its sales and possibly lead to licensing agreements after successful trials of the Corporation's technologies.

The current management has demonstrated that it can secure outside working capital when required, as evidenced by the successful closings of its five Private Placements with gross proceeds of \$2,936,138 in the second half of FY 2007, its closing of a non-brokered private placement with gross proceeds of \$999,000 in Q3 FY 2008 and followed by a brokered private placement of \$15,000,000 in Q1 FY 2009.

Management believes that by maintaining its small core of personnel and high margins on more secured contracts that it will achieve profitable operations. Small incremental staffing increases will be introduced from time to time depending on the demand arising from increased sales volumes.

Management has expanded its suite of energy savings solutions by acquiring the award-winning, patented DRY-REX™ bioenergy technology from Mabarex Inc., of Montreal (www.mabarex.com). With this agreement, the Company took immediate ownership of the exclusive worldwide license to the DRY-REX™ technology and the transfer of all intellectual property (patent) rights on an earn-out basis over five years. This adds to the Company's previous acquisition of new licenses and distributorship rights to GEM®, a leading European (Great Britain) line of industrial/commercial steam traps and THERMALOZOMAX™, an ozone generation technology. This was followed in Q1 FY 2009 with the Company entering into an agreement to acquire Bristol-based Gardner Energy Management Ltd. (GEM) (www.gemtrap.com)

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 technologies of FLU-

ACE™ and DRY-REX® is limited at this time and in any event believes that the market place is sufficiently large enough to permit stronger competition in the future and firmly believes 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 SCUT focused on the commercialization of the Company's THERMALONOX™ nitrogen oxides 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.

Financial Information (Cont'd)

- 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.
 - 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 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.
 - 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).
 - On 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.
 - On October 29, 2007, the Company announced that it had completed its first waste heat recovery project in the U.S., valued at \$1.4 M.
 - On November 1, 2007, the Company announced that it had received a second order for 39 GEM® steam traps at the Jiangsu Huachang Chemical Co.'s plant in China. The order was secured by Jiangnan Boilers and Pressure Vessels Company Ltd. (JBPV), in advance of completing a joint venture agreement under development between the Company and JBPV, a multi-billion dollar, national large scale chemical enterprise.
 - On November 20, 2007, the Company announced that it was being honoured by the Ottawa Section of the Institute of Electrical and Electronics Engineers (IEEE) with an award for its innovative technology and success in providing custom energy and emission reduction solutions.
 - On November 28, 2007, the Company announced that it was entering as majority owner through its wholly-owned subsidiary (Thermal Energy International (Guangzhou) Ltd.) into a joint venture with Oriental-Unicorn Sales and Marketing Co., of Guanzhou, China and E5 Enterprises LLC, of Markham, Ontario. Oriental-Unicorn was instrumental in the Company's first sale of GEM® steam traps to Lee & Man Paper Co.
 - On December 13, 2007, the Company announced that it had secured a five-year, \$2.5 million line of credit with the Toronto-Dominion Bank to facilitate the Company's co-investment in assets such as FLU-ACE® and DRY-REX™ systems using its THERMAL-AUD Program through its wholly owned subsidiary, ForEverGreen Energy Inc. The Company's first commercial line of credit with a leading financial institution was partially supported by guarantees by Export Development Corporation because it was deemed to contribute to export-related sales.
 - On January 21, 2008, the Company announced that it had closed a non-brokered private placement with gross proceeds of \$999,000. The financing consisted of the issuance of 1,455,000 units, with each unit comprising one common share and one non-transferable share purchase warrant entitling the holder to acquire one additional common share at an issuance price of \$0.50 per warrant any time within two years of issuance, and, 1,875,000 units, each unit comprising one "flow-through" common share. A total of 3,300,000 units were sold at the deemed price of \$0.30 per share. The proceeds of the private placement will be used to support on-going sales and marketing.
 - On February 20, 2008, the Company announced that Natural Resources Canada (NRCan) had committed \$900,000 in funding toward the development of a green energy power facility proposed for an eastern Canada pulp and paper mill. The funding will be provided under a repayable contribution agreement from NRCan's Climate Change Interim Strategy Technology Early Action Measures (TEAM) Fund to demonstrate the performance and energy efficiency improvements of a combined biomass dryer/energy recovery system in order to reduce emissions and fossil fuel use at a Canadian pulp and paper mill.
 - On March 4, 2008, the Company announced that it had received a new initial order for the GEM Condensate Return System from one of Canada's largest energy-related companies.
 - On March 6, 2008, the Company announced that it had established a DRY-REX™ test facility to handle funded research projects on drying different sources of biomass for use as biofuels. The laboratory has already received its first contract from an Italian firm to conduct drying tests on grape pressings and orange pressings. This represents one of several requests from potential customers in Europe's bioenergy sector.
 - On March 27, 2008, the Company announced that an alliance of international leaders in energy efficiency and energy financing will launch a new energy saving services program early next month targeting energy intensive industries in China. The consortium is led by Honeywell Building Solutions and Asia Clean Capital Limited and includes Solar Turbines Inc. and the Company. The energy savings solutions will offer state-of-the-art energy savings technologies focusing on energy recovery, steam system efficiency, co-generation and tri-generation solutions.
 - On April 7, 2008, the Company announced that it had entered into an agreement to acquire Bristol based Gardner Energy Management Ltd. The contemplated transaction consists of a base price of £2.7 million (approximately \$5.4 million CAD) payable upon closing, and an amount of £1.3 million (approximately \$2.6 million CAD) payable in a combination of cash and shares on an earn-out basis over a three year period based on the future performance of the GEM business line. The transaction is expected to close on or before July 4, 2008, subject to financing and to regulatory approvals.

Financial Information (Cont'd)

- On April 11, 2008, the Company gave an update on the successful launch of the new energy savings program by an alliance of international leaders in energy savings and energy financing. The launch event was attended by senior executives of major companies from the textile, pulp and paper and other energy-intensive industries as well as local and foreign government representatives and key industry associations.
 - On April 17, 2008, the Company announced that its new energy services subsidiary ForEverGreen Energy Inc. has commenced delivery of a "green" energy supply contract to provide Fraser Papers Inc.'s Thurso pulp mill with recovered waste heat. The green power purchase agreement is for six years and is worth up to \$3.75M based on the estimated amount of heat from waste heat.
 - On April 23, 2008, the Company announced that it had been engaged to commence work for a major FLU-ACE® energy recovery system at a fine paper mill in the north eastern United States. The first phase of the project for the client, a multinational forest products company, is the detailed design and engineering work which serves to confirm the implementation costs and financial benefits from the energy savings generated through waste heat recovery to offset fossil fuel use. The initial study for the customer in 2007 estimated the capital investment of a FLU-ACE® energy recovery solution at approximately \$3 million with a simple payback of less than three years.
- 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 commons 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.

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 2009, the Corporation has been focused equally on direct sales and cooperative sales development activities in Canada, USA and China. The majority of the Corporations' sales, marketing, and business development resources have been utilized equally in support of the Johnson Controls' cooperative energy solutions sales development activities; as well as 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. This has led to the submission of several proposals currently including the Company's THERMAL-AUD™ program with clients for approval and several invitations to other client sites for submission of other proposals.

The Corporation anticipates that these initiatives will not only produce increased sales revenues and gross profit in the third quarter FY 2009 (ending February 28, 2009) but become a harbinger for continued improvement to the Consolidated Balance Sheet.

- On June 3, 2008, the Corporation announced that it had entered into an agreement with a North American integrated paper company for the delivery of a green energy supply program worth in excess of \$20M, using recovered waste heat at one of its facilities in the north eastern United States.
- 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

Financial Information (Cont'd)

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

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 with 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.



Tim Angus
President & CEO



Oliver Toffoli
Chief Operating Officer & CFO



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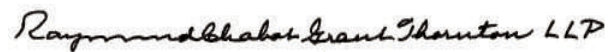
AUDITOR'S REPORT

To the shareholders of
Thermal Energy International Inc.

We have audited the consolidated balance sheets of Thermal Energy International Inc. as at May 31, 2008 and 2007 and the consolidated statements of operations, comprehensive loss 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, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants,
Licensed Public Accountants

Ottawa, Canada
September 23, 2008

Financial Information (Cont'd)

Thermal Energy International Inc.

Incorporated under the Ontario Business Corporations Act

CONSOLIDATED BALANCE SHEETS

As at May 31

	2008	2007
	\$	\$
ASSETS		
Current assets		
Cash	84,717	549,196
Short term investments (note 5)	552,773	1,020,880
Accounts receivable (note 6)	627,571	428,581
Contracts in progress	156,000	4,000
Net investments in lease	227,034	-
Prepays and other assets	31,934	60,894
	1,680,029	2,063,551
Property, plant and equipment (note 7)	65,066	67,612
Net investment in lease (note 8)	1,948,906	-
	3,694,001	2,131,163
LIABILITIES, CAPITAL STOCK, CONTRIBUTED SURPLUS AND DEFICIT		
Current liabilities		
Bank loan (note 9)	908,667	-
Accounts payable	2,001,801	328,182
Accrued liabilities	459,777	158,082
Deferred revenue	384,908	1,000,000
Due to past President (note 10)	17,937	17,937
	3,773,090	1,504,201
Capital stock, contributed surplus and deficit		
Capital stock (note 11)	19,479,079	17,459,549
Contributed surplus (note 11)	1,528,414	1,881,487
Deficit	(21,086,582)	(18,714,074)
	(79,089)	626,962
	3,694,001	2131,163

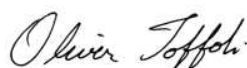
Contingency (note 19)

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

On behalf of the Board



Tim Angus
President & CEO



Oliver Toffoli
Chief Operating Officer & CFO

Financial Information (Cont'd)

CONSOLIDATED STATEMENT OF CASH FLOWS

Year ended May 31

	2008	2007
	\$	\$
OPERATING ACTIVITIES		
Net loss for the year	(2,372,508)	(2,443,265)
Add items not involving cash:		
Stock-based compensation charge	495,786	377,755
Amortization of property, plant and equipment	31,314	24,828
Future income taxes	(200,000)	(195,000)
Write-off of past President loan to acquire shares	-	151,500
Non-monetary compensation charge	152,171	13,031
Changes in non-cash operating working capital		
Accounts receivable	(198,990)	197,914
Contracts in progress	(152,000)	85,000
Prepays and other assets	28,960	(19,117)
Accounts payable	1,673,619	(437,487)
Accrued liabilities	301,695	(8,646)
Deferred revenue	(615,092)	901,000
Net cash used in operating activities	(855,045)	(1,352,487)
INVESTING ACTIVITIES		
Disposal (aacquisition) of short term investments	468,107	(1,020,880)
Additions to property, plant and equipment	(28,762)	(32,902)
Decrease in loan receivable	-	55,000
Net cash used in investing activities	439,339	(998,282)
FINANCING ACTIVITIES		
Increase in bank loan	908,667	-
Net investment in lease (note 8)	(2,209,842)	-
Lease payments received	33,902	-
Common shares issued (note 11)	1,218,550	2,840,846
Net cash provided by financing activities	(48,773)	2,840,846
Increase (decrease) in cash for the year	(464,479)	490,077
Cash, beginning of year	549,196	59,119
Cash, end of year	84,717	549,196
Interest paid	5,444	3,242
Tax impact of renounced expenditures	200,000	195,000
Shareholder loans to acquire shares	529,977	7,500

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

Financial Information (Cont'd)

CONSOLIDATED OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT

Year ended May 31

	2008	2007
	\$	\$
REVENUE		
Sales	4,926,208	821,024
Cost of sales	4,318,184	874,515
Gross profit (loss)	608,024	(53,491)
Expenses		
Administration	1,228,984	880,331
Selling, marketing and business development	1,314,208	1,266,359
Legal fees	331,836	18,850
Audit fees	72,839	77,500
Insurance	127,993	78,498
Amortization of property, plant and equipment	31,314	24,828
Patent and trademark maintenance	13,587	23,715
Research and development	87,572	99,875
Interest and bank charges	20,417	16,832
Foreign exchange loss (gain)	40,081	67,787
	3,268,831	2,554,575
Loss before the following:	(2,660,807)	(2,608,066)
Interest revenue	32,098	562
Finance revenue	56,201	-
Other revenue	-	5,240
Other costs	-	(36,001)
Loss before income taxes	(2,572,508)	(2,638,265)
Future income tax recovery (note 14)	200,000	195,000
Net loss and other comprehensive loss	(2,372,508)	(2,443,265)
Deficit, beginning of year	(18,714,074)	(16,270,809)
Deficit, end of year	(21,086,582)	(18,714,074)
Net loss per share - basic and diluted	(0.025)	(0.031)
Weighted average number of common shares	94,665,536	78,443,983

The accompanying notes are an integral part of these consolidated financial statements and Note 15 provides other information on earnings.

Financial Information (Cont'd)

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 and as at May 31, 2008 no financial covenant was met.

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, its ability to generate sufficient cash from operations and its ability to operate with a gross margin.

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 applicable to consolidated financial statements.

On June 1, 2007, in accordance with the applicable transitional provisions, the Company applied the recommendations of new Section 1506, "Accounting Changes", of the Canadian Institute of Chartered Accountants' (CICA) Handbook. This new section, effective for the years beginning on or after January 1, 2007, prescribes the criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. Furthermore, the new standard requires the communication of the new primary sources of GAAP that are issued but not yet effective or not yet adopted by the Company. The new standard had no impact on the Company's financial results.

Effective June 1, 2007, the Company adopted the new recommendations 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, measurement and presentation and disclosure of financial instruments.

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. This change had no impact on the consolidated financial statements as at May 31, 2008.
- 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 and May 31, 2008, there was no adjustment to the opening or closing 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 consolidated financial statements as at May 31, 2008.

- The bank loan, 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 consolidated financial statements as at May 31, 2008.
- Long-term debt is classified as other financial liabilities. It is measured at amortized cost using the effective interest method. This change had no impact on the consolidated financial statements as at May 31, 2008.

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. 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. Such estimates include determination of the percentage of completion for contracts and assumptions used in the Black-Scholes fair value calculations. 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.

Amortization

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

Thermal-AUD™ plant and equipment	Straight-line based on terms of contract
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 12 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.

Financial Information (Cont'd)

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.

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 net minimum lease payments and unearned finance income.

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.

Share issue expenses

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

5 SHORT TERM INVESTMENTS

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

6 ACCOUNTS RECEIVABLE

	2008 \$	2007 \$
Trade	438,592	377,124
Commodity taxes	145,928	22,764
Directors and Officers	34,500	-
Other	8,551	28,693
	627,571	428,581

At May 31, 2008, 68% (2007 - 94%) of trade receivables were from one customer.

7 PROPERTY, PLANT AND EQUIPMENT

	2008		2007	
	Cost \$	Accumulated Amortization \$	Cost \$	Accumulated Amortization \$
Furniture and fixtures	81,671	66,330	81,671	62,597
Laboratory equipment	52,857	21,073	46,675	14,183

Computers	157,861	144,787	140,166	133,675
Software	16,971	14,525	12,081	12,081
Leasehold improvements	21,401	18,980	21,401	11,846
	330,761	265,695	301,994	234,382
Accumulated amortization	(265,695)		(234,382)	
Net book value	65,066		67,612	

8 NET INVESTMENT IN LEASE

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

	2008 \$
Total minimum lease payments receivable	3,605,747
Unearned income	1,429,807
	2,175,940
Less: current portion	(227,034)
	1,948,906

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

	\$
2009	615,972
2010	615,972
2011	615,972
2012	615,972
2013	615,972
2014	525,887
	3,605,747

9 BANK LOAN

During the year, the Company obtained bank financing with an authorized amount of \$2,500,000. At May 31, 2008 this loan, secured by accounts receivable and a general security agreement with interest rate at prime plus 0.25% amounted to \$908,667 (2007 - \$Nil). Prime rate at May 31, 2008 is 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, 2008 no financial covenant was met.

10 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.

	2008	2007
Balances owing to/from directors		
Accounts receivable	\$ 34,450	-
Loans receivable	\$ 289,647	-
Accrued liabilities	\$ 75,534	\$ 18,750

Directors share options and warrants outstanding at May 31

Issued	3,500,000	4,000,000
Exercisable	2,461,000	3,233,000
Warrants outstanding	37,500	-

Balances owing to/from officers

Accounts receivable	\$ 8,000	\$ 192,000
Loan receivable	\$ 319,800	-
Accrued liabilities	-	\$ 7,500

Financial Information (Cont'd)

	2008	2007
Officers share options and warrants outstanding at May 31		
Issued	-	1,993,000
Exercisable	-	1,434,000
Transactions with directors and officers were as follows:		
Directors fees for services	\$ 116,750	\$ 36,750
Officers fees for services	\$ 188,000	\$ 192,000
Shares issued to Directors	2,366,667	293,125
Shares issued to Officers	1,843,000	268,081

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

11 CAPITAL STOCK AND CONTRIBUTED SURPLUS

	2008		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 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.				
Class A Common shares issued				
Balance, beginning of year	90,918,419	17,573,323	74,570,256	14,733,084
Issued in settlement of liabilities	350,685	104,848	1,160,584	181,393
Issued for cash, net of flow through share tax benefit (i)	4,190,000	1,867,359	15,137,579	2,645,846
Issued as a result of the exercise of options(ii)	3,593,000	577,300	50,000	13,000
	99,052,104	20,122,830	90,918,419	17,573,323
Less: loans outstanding to assist shareholders in purchasing capital stock (ii)		(643,751)		(113,774)
Balance, end of year	99,052,104	19,479,079	90,918,419	17,459,549

(i) In fiscal 2008, the Company renounced expenditures of \$615,000 (2007 - \$540,000) from 4,190,000 (2007 - 3,484,334) flow-through common shares issued during the respective fiscal years. The resulting future income tax recovery of \$200,000 (2007 - \$195,000) was charged against capital stock as share expenses.

	2008	2007
	\$	\$
Loans to exercise options:		
Directors and officers	577,300	13,000

Loans were extended to directors and officers to acquire shares of the Company through the exercise of options. These loans are for a two year period with an interest rate of 5%. 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 within the two year period at which time the shares with an equivalent value to the repayment will be released to the borrower by the Company.

(iii) Repayments made on these loans during the year were \$47,323 (2007 - \$170,031)

	2008	2007
	\$	\$
President	124,647	46,970
Directors and Officers	361,800	7,500
Other shareholders	157,304	59,304
	643,751	113,774

Stock-based compensation on these loans was estimated using the Black-Scholes option pricing model with the following assumptions:

	Loans to exercise options		Loans to acquire shares	
	2008	2008	2007	
Weighted average assumptions:				
Expected dividend	0%	0%	0.00%	
Expected volatility	80%	98%	74%	
Risk-free interest rate	4.50%	4.50%	3.85%	
Expected option life in years	2.0	1.0	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 539,000 options to directors to purchase common shares at \$0.16 per share based on Company performance and which will expire on December 20, 2009.

(a) In fiscal 2008 and 2007 the Company completed private placements. In both years funds were raised by issuing Units that included one Class A common share and one non-transferable share purchase warrant. In 2008, funds were also raised by issuing flow-through shares. Activity in share purchase warrants was as follows:

	2008		2007	
	# Warrants	Weighted Average Exercise Price \$	# Warrants	Weighted Average Exercise Price \$
Balance, beginning of period	14,480,390	0.35	10,154,896	0.30
Issued	1,517,500	0.50	7,312,162	0.37
Exercised	(392,828)	0.32	-	-
Expired	(6,816,561)	0.32	(2,986,668)	0.25
Balance, end of period	8,788,501	0.40	14,480,390	0.35

Financial Information (Cont'd)

(b) The following table summarizes the status of warrant outstanding at May 31, 2008:

Warrants Outstanding	Exercise Price \$	Expiry Date
760,000	0.30	To October 10, 2008
260,000	0.30	To November 2, 2008
229,084	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
1,517,500	0.50	To December 7, 2009
8,788,501		

Contributed surplus

	2008 \$	2007 \$
Balance, beginning of year	1,881,487	1,509,232
Stock-based compensation	495,786	377,755
	2,377,273	1,886,987
Fair-value of options exercised and transferred to capital stock	848,859	5,500
Balance, end of year	1,528,414	1,881,487

12 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:

	\$
2009	109,800
2010	84,800
2011	4,800
2012	4,800
2013	400
Total	204,600

13 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 2008 and 2007 had vesting periods ranging from four to twelve months.

(a) Activity in stock options was as follows:

	2008		2007	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of year	8,368,000	0.17	4,718,714	0.17
Granted	1,850,000	0.30	4,475,000	0.17
Exercised	(4,210,857)	0.17	(50,000)	0.15
Forfeited	(150,000)	0.21	(250,000)	0.19
Expired	-	-	(525,714)	0.16
Outstanding, end of year	5,857,143	0.21	8,368,000	0.17
Number of options exercisable as at May 31	4,779,143		6,126,000	

Options exercised during the year were as follows:

	2008		2007	
	# shares	\$	# shares	\$
Employees	1,885,857	320,300	50,000	7,500
Directors	1,750,000	265,000	-	-
Consultants	575,000	117,000	-	-
	4,210,857	702,300	50,000	7,500

In fiscal 2008, 3,593,000 options were exercised in consideration of loans receivable of \$577,300 (2007 - 50,000 for \$7,500), 475,000 options were exercised for cash of \$95,000 and 142,857 options were exercised as a settlement of debt in the amount of \$30,000

(b) The following options are outstanding and/or exercisable at May 31, 2008:

Number of Options Outstanding	Number of Options Exercisable	Exercise Price Per Share \$	Expiry Date
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
57,143	57,143	0.21	September 7, 2009
3,000,000	2,422,000	0.16	December 20, 2009
500,000	500,000	0.20	March 15, 2010
350,000	350,000	0.37	June 11, 2010
300,000	300,000	0.35	June 15, 2010
100,000	100,000	0.43	July 20, 2010
500,000	500,000	0.20	January 25, 2011
250,000	-	0.285	April 29, 2011
250,000	-	0.27	May 16, 2011
5,857,143	4,779,143		

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:

	2008	2007
Weighted average assumptions:		
Expected dividend	0.00%	0.00%
Expected volatility	88%	90%
Risk-free interest rate	4.50%	3.85%
Expected option life in years	2.4	2.4

Stock-based compensation expense in fiscal 2008 includes an amount of \$114,235 for options granted to consultants (2007 - \$20,505). Employee stock-based compensation expense is \$381,551 (2007 - \$357,250).

14 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:

	2008 \$	2007 \$
Loss before income taxes	(2,572,508)	(2,638,265)
Income taxes calculated using the combined federal and provincial income tax rate in Canada of 35.45% (2007 - 36.12%)	(912,000)	(952,900)

Financial Information (Cont'd)

	2008 \$	2007 \$
Stock-based compensation	175,800	136,400
Other	3,300	3,800
Effect of change in tax rates	788,700	-
Effect of changes in valuation allowance	(255,800)	617,700
Future income tax provision (recovery)	(200,000)	(195,000)

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

	2008 \$	2007 \$
Future income tax assets		
Non-capital losses	2,457,800	2,289,300
Intangible assets	794,300	989,300
Property, plant and equipment	502,200	99,700
Share issue costs	-	800
	3,754,300	3,379,100
Future income liabilities		
Lease adjustment	(631,000)	-
Net future income tax asset before valuation allowance	3,123,300	(3,379,100)
Valuation allowance	(3,123,300)	(3,379,100)
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 2008, the Company renounced approximately \$615,000 (2007 - \$540,000) of expenditures. At May 31, 2008 and 2007 there are no expenditures that are required to be incurred before December 31, 2008. Participation in this program is subject to verification by tax authorities with respect to the nature and timing of expenditures.

As at May 31, 2008, 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
2028	2,137,000
Total	8,475,000

15 INFORMATION INCLUDED IN OPERATIONS

	2008 \$	2007 \$
Interest expense	15,223	13,570

Administration expense and selling, marketing and business development expense are presented

net of government assistance of \$20,203 and \$196,922 respectively.

16 SEGMENTED INFORMATION

In fiscal 2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America 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 two retrofit technology lines – waste energy recovery solutions and air pollution control solutions. In fiscal 2008 revenue was 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.

Prior to fiscal 2008, customers financed these projects entirely from their own resources and accordingly, the Company operated in only one segment. In 2008 the Company introduced its Thermal-AUD™ product whereby it finances the project, recovers and obtains a return on its investment by leasing back the facility on an agreed basis to the customer. Construction of the first Thermal-AUD™ project was completed in late fiscal 2008. This gave rise to two reportable segments which are detailed below:

	May 31, 2008 Customer financed contracts and other \$	Thermal-AUD™ contract \$
Revenue from external customers	2,716,366	2,209,842
Inter-segment revenues	19,111	-
Interest and finance revenue	32,098	56,201
Interest expense and bank charges	13,503	6,914
Stock-based compensation charge	495,786	-
Amortization of capital assets	31,314	-
Segment loss (profit)	2,391,014	(18,506)
Segment assets	2,755,526	2,225,562
Expenditures for capital assets	28,768	-
Reconciliation to financial statements		
		May 31, 2008 \$
Revenues		
Total revenues for reporting segments	4,945,319	
Elimination of inter-segment revenues	(19,111)	
Total company revenues	4,926,208	
Loss		
Total loss for reported segments	2,572,508	
Income tax recovery	(200,000)	
Net loss	2,372,508	
Assets		
Total assets for reported segments	4,981,088	
Elimination of inter-segment receivables	(1,287,087)	
Total assets	3,694,001	

Other significant items	Segment totals \$	Adjustments \$	Company totals \$
Interest revenue	32,098	-	32,098
Interest expense and bank charges	20,417	-	20,417
Finance revenue	56,201	-	56,201
Stock-based compensation charge	495,786	-	495,786
Amortization of capital assets	31,314	-	31,314
Expenditures for capital assets	28,768	-	28,768

Financial Information (Cont'd)

Geographic Segments	May 31, 2008	
	Revenues \$	Capital Assets \$
Canada	2,382,444	2,013,972
United States	2,507,137	-
China	36,627	-
Total	4,926,208	2,013,972

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

Two unaffiliated customers accounted for 94% of sales in 2008 and two unaffiliated customers for 100% in 2007.

17 FINANCIAL RISKS

Interest rate risk

The Company has contracted a short-term bank loan bearing a floating rate of interest. This financial instrument exposes the Company to risk in the event market interest rates fluctuate.

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, 2008, cash, short-term investments, accounts receivable and accounts payable denominated in U.S. dollars totalled US\$7,115, US\$200, US\$394,798 and US\$824,252 respectively (US\$244,694, US\$300,000, US\$343,075 and US\$29,390 as at May 31, 2007).

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

Credit risk

The financial instruments that potentially expose the Company to credit risk are accounts receivable and loans outstanding to assist shareholders in purchasing capital stock. At May 31, 2008, 68% (2007 – 94%) of trade receivables were from one customer.

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

Given that they will mature shortly, the fair value of short-term financial assets and liabilities are equivalent to their carrying amount.

18 COMPARATIVE AMOUNTS

Certain 2007 amounts have been reclassified to conform with the current year's presentation.

19 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 had filed its statement of defence and had 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.

20

RECENTLY ISSUED ACCOUNTING STANDARDS NOT YET IMPLEMENTED

Capital disclosures and financial instruments disclosures and presentation

Between December 2006 and February 2008, the CICA issued the following new standards: Section 3862 "Financial Instruments – Disclosures", Section 3863 "Financial Instruments – Presentation", Section 1535 "Capital Disclosures", Section 1400 "General Standards of Financial Statement Presentation", Section 3064 "Goodwill and Intangible Assets" and Section 3031 "Inventories". These 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 replaces 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.

Section 1400 requires that management make an assessment of the Company's ability to continue as a going concern over a period which is at least, but is not limited to, twelve months from the balance sheet date.

Section 3064 establishes 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.

Section 3031 "Inventories", provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

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

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SUBSEQUENT EVENTS

On June 3, 2008 the Company announced that it had closed a brokered private placement of 68,181,818 common shares at \$0.22 per share for gross proceeds of \$15,000,000. The funds raised were to complete the acquisition of Gardner Energy Management Ltd. in the United Kingdom for approximately \$5,400,000 and to provide funds to finance the construction of plant and equipment for future ThermalAud™ contracts.

On July 2, 2008 the Company announced that it had completed the acquisition of Gardner Energy Management Ltd. of Bristol, England. The terms of the acquisition required the company to make an initial payment of £2,700,000 sterling or approximately \$5,400,000 upon closing July 1, 2008. An additional payment of up to £1,300,000 sterling or approximately \$2,600,000 may be made in cash and shares over a three year period based on Gardner Energy Management Ltd. meeting certain performance targets.

Information for Shareholders

Board of Directors

John R. Parker, Chairman of the Board
Tim K. Angus
R. James Ansell
William Crossland
Clint Sharples
Michael Williams
John Kelly

Officers and Senior Management

Tim Angus
President and Chief Executive Officer

Oliver Toffoli, P. Eng
Chief Operating Officer and Chief Financial Officer

Robert Triebe, M.A.Sc., P. Eng
Chief Technology Officer

Anthony J. Pugliese
Vice President, Sales

Denis Forget, P. Eng
Director of Project Development
Vice President, Strategic Business Development

Stuart McCarthy
Director, Marketing & Communications

Tim Gardner
Managing Director, GEM

Gustav Pliva
Manager, Corporate Development & Human Resources & Corporate Secretary

Auditors

Raymond Chabot Grant Thornton LLP

General Counsel

Heenan Blaikie LLP

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) under the symbol "TMG"

Investor Relations

Stuart McCarthy
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(613) 723-6776 x 220

Annual Meeting

The Annual Meeting of Shareholders will be held on:
Tuesday, November 25, 2008, at 9:00 a.m. EST
Brookstreet Hotel
525 Legget Drive,
Kanata, Ontario

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