



Leading Edge Environmental Compliance and Energy Conservation Solutions



First Quarter Report - FY 2007

August 31, 2006

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

CONSOLIDATED BALANCE SHEETS

As at	(Unaudited) Aug 31 2006 \$	May 31 2006 \$
ASSETS		
Current assets		
Cash	61,874	59,119
Accounts receivable (note 6)	208,407	626,495
Contracts in progress	-	89,000
Prepays and other assets	66,308	41,777
	336,589	816,391
Loans receivable (note 8)	37,000	55,500
Property, plant and equipment (note 9)	86,027	59,539
	459,616	931,430
LIABILITIES, CAPITAL STOCK, CONTRIBUTED SURPLUS AND DEFICIT		
Current liabilities		
Accounts payable	884,490	947,063
Accrued liabilities	202,648	166,728
Deferred revenue	116,000	99,000
Due to past President (note 7)	17,937	17,937
	1,221,075	1,230,728
Capital stock, contributed surplus and deficit		
Capital stock (note 10)	14,503,579	14,462,279
Contributed surplus (note 10)	1,517,782	1,509,232
Deficit	(16,782,820)	(16,270,809)
	(761,459)	(299,298)
	459,616	931,430

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

On behalf of the Board

Tim Angus
 President and C.E.O.

Oliver Toffoli
 Chief Financial Officer

THERMAL ENERGY INTERNATIONAL INC.**CONSOLIDATED OPERATIONS AND DEFICIT
(Unaudited)**

Three months ended August 31

	2006	2005
	\$	\$
REVENUE		
Sales	102,659	382,180
Cost of sales	150,122	329,355
Gross profit (loss)	(47,463)	52,825
Expenses		
Administration	118,544	106,394
Selling, marketing and business development	237,599	200,812
Stock-based compensation expense (note 10)	8,550	288,189
Legal fees	12,670	17,094
Audit fees	15,000	11,250
Insurance	18,828	20,637
Amortization of property, plant and equipment	6,413	2,991
Patent and trademark maintenance	4,932	6,355
Research and development	24,659	9,853
Interest and bank charges	1,201	739
Foreign exchange loss (gain)	1,591	(4,555)
	449,987	659,759
	(497,450)	(606,934)
Other revenue (note 13)	-	221,286
Interest revenue	123	5,037
Other costs (note 14)	(14,684)	-
Net loss	(512,011)	(380,611)
Deficit, beginning of period	(16,270,809)	(14,054,076)
Deficit, end of period	(16,782,820)	(14,434,687)
Net loss per share - basic and diluted	(0.01)	(0.01)
Weighted average number of common shares	74,669,876	64,423,478

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

THERMAL ENERGY INTERNATIONAL INC**CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)**

Three months ended August 31

	2006	2005
	\$	\$
OPERATING ACTIVITIES		
Net loss for the period	(512,011)	(380,611)
Add items not involving cash:		
Non-monetary compensation charge	8,550	288,189
Amortization of property, plant and equipment	6,413	2,991
Changes in non-cash operating working capital		
Accounts receivable	418,088	(296,719)
Contracts in progress	89,000	-
Prepays and other assets	(24,531)	7,611
Accounts payable	(62,573)	148,160
Accrued liabilities	77,220	(86,924)
Deferred revenue	17,000	371,000
Changes in due to the past President (note 7)	-	(246,487)
Net cash used in operating activities	<u>17,156</u>	<u>(192,790)</u>
INVESTING ACTIVITIES		
Additions to short term investments	-	(5,000)
Additions to property, plant and equipment	(32,901)	(3,682)
Net cash used in investing activities	<u>(32,901)</u>	<u>(8,682)</u>
FINANCING ACTIVITIES		
Common shares issued net of issue costs (note 10)	-	348,833
Decrease in loan receivable	18,500	-
Net cash provided by financing activities	<u>18,500</u>	<u>348,833</u>
Increase in cash for the period	2,755	147,361
Cash beginning of period	59,119	174,218
Cash end of period	<u>61,874</u>	<u>321,579</u>
Interest paid	<u>644</u>	421

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1 These interim unaudited financial statements follow the same accounting policies and methods as in the audited financial statements prepared for the year ended May 31, 2006 and should be read in conjunction with those statements.

2 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.

3 GOING CONCERN

The Company incurred losses from operations in the quarter ended August 31, 2006 and 2005. It had a working capital deficiency at August 31, 2006 and at August 31, 2005.

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

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

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

4 CHANGES IN ACCOUNTING POLICIES

In March 2004, the CICA issued Emerging Issue Committee Abstract no 146 (EIC-146) "Flow-through Shares", which applies to flow-through share issuances initiated after March 19, 2004. The Corporation adopted prospectively the new recommendations and now records the tax effect related to renounced deductions on the date that the Corporation renounced the deductions to investors.

5 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies are as follows:

Basis of consolidation

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

Use of estimates

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

Revenue recognition

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

Cash and cash equivalents

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Amortization

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

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

Loss per share

The basic loss per share is calculated on the basis of net loss divided by the weighted average number of common shares outstanding during the year. The diluted per share amount is calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options. 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.

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 period.

Investment tax credits

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

Stock-based compensation

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

Share purchase loans are accounted for in accordance with EIC Abstract 132 "Share Purchase Financing". These loans, which were extended to shareholders to purchase Class A common shares, are considered to be stock options and are treated as stock-based compensation and recorded at their fair market value.

THERMAL ENERGY INTERNATIONAL INC.

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

6 ACCOUNTS RECEIVABLE

	Aug 31, 2006	May 31, 2006
	\$	\$
Trade	167,450	517,914
Other	40,957	108,581
	208,407	626,495

At August 31, 2006, 80% of trade receivables and 91% of revenues were from one customer. At August 31, 2005 all trade receivables and revenues were from one customer.

7 RELATED PARTY TRANSACTIONS

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

	Aug 31, 2006	Aug 31, 2005
	\$	\$
Transactions with and balances owing to/from directors		
Loans receivable	37,000	-
Accrued liabilities	-	6,750
Flow-through shares issued	200,000	-
Directors share options outstanding at Aug 31		
Issued	2,300,000	2,525,000
Exercisable	1,985,000	2,180,000
Transactions with and balances owing to/from officers		
Fees for services	48,000	46,500
Accounts receivable	2,955	2,955
Accrued liabilities	-	2,667
Common shares issued	16,500	
Officers share options outstanding at Aug 31		
Issued	1,043,000	1,043,000
Exercisable	885,500	870,000

THERMAL ENERGY INTERNATIONAL INC.

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

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

	Aug 31, 2006	May 31, 2006
	\$	\$
Balance due to the past President, beginning of period	17,937	300,972
Debt settlement	-	(232,305)
Cash payment to Past president	-	(50,000)
Payments made on behalf of past President	-	(730)
Balance due to the past President, end of period	17,937	17,937

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

8 LOANS RECEIVABLE

Loans receivable of \$37,000 represents an amount due from a director (2005 - \$nil).

9 PROPERTY, PLANT AND EQUIPMENT

	Aug 31, 2006		May 31, 2006	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Furniture and fixtures	128,346	68,229	81,671	58,176
Computers	140,165	129,161	153,939	134,584
Software	12,081	12,081	12,081	12,081
Leasehold improvements	21,401	6,495	21,401	4,712
	301,993	215,966	269,092	209,553
Accumulated amortization	(215,966)		(209,553)	
Net book value	86,027		59,539	

THERMAL ENERGY INTERNATIONAL INC.

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

10 CAPITAL STOCK AND CONTRIBUTED SURPLUS

	Aug 31, 2006		May 31, 2006	
	# Shares	\$	# Shares	\$
Authorized				
Unlimited number of Class A common shares, no par value				
Unlimited number of Series 1 preferred shares, voting only in the case of dissolution of the Company, redeemable at the option of the Company 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 period	74,570,256	14,733,084	63,198,899	12,776,987
Issued in settlement of liabilities, net of issue costs	295,000	41,300	1,247,432	179,235
Issued for cash, net of issue costs	-	-	8,573,925	1,377,772
Issued as a result of the exercise of options	-	-	1,550,000	399,090
	74,865,256	14,774,384	74,570,256	14,733,084
Less: loans outstanding to assist a shareholder in purchasing capital stock (i)		(270,805)		(270,805)
Balance, end of quarter	74,865,256	14,503,579	74,570,256	14,462,279

(i) The past President received shareholder loans of \$151,500 to purchase shares during 1999. The current President received a shareholder loan of \$60,000 to purchase shares in the fiscal year 2006. These loans are due upon demand, bear no interest and have no fixed repayment terms.

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

The following table summarizes the status of warrants outstanding at Aug 31, 2006:

Warrants Outstanding	Exercise Price \$	Expiry Date
2,586,668	0.20	To November 4, 2006
400,000	0.60	To January 18, 2007
3,300,333	0.35	To June 3, 2007
3,867,895	0.30	To April 22, 2007
10,154,896		

Contributed surplus

	Aug 31, 2006	May 31, 2006
	\$	\$
Balance, beginning of period	1,509,232	1,237,995
Stock-based compensation	8,550	431,827
	1,517,782	1,669,822
Fair-value of options exercised and transferred to capital stock	-	160,590
Balance, end of period	1,517,782	1,509,232

THERMAL ENERGY INTERNATIONAL INC.

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

11 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:

	\$
2007	81,500
2008	96,900
2009	35,000
2010	2,000
Total	215,400

12 SHARE OPTION PLAN

The Company established the Company's Share Option Plan applicable to Directors, Officers, 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. There were no new options granted in the first quarter ended August 31, 2006. Options granted in the first quarter ended August 31, 2005 had vesting periods of four months.

(a) Activity in stock options was as follows:

	Aug 31, 2006		May 31, 2006	
	# Options	Weighted Average \$	# Options	Weighted Average \$
Outstanding, beginning of period	4,718,714	0.17	7,043,714	0.16
Granted	-		850,000	0.23
Exercised	-		(1,550,000)	0.15
Cancelled	(200,000)	0.18	(975,000)	0.18
Expired	-		(650,000)	0.15
Outstanding, end of period	4,518,714	0.17	4,718,714	0.21
Number of options exercisable as at Aug 31	3,942,464		4,024,964	

Options exercised during the period were as follows:

	Aug 31, 2006		May 31, 2006	
	# shares	\$	# shares	\$
Employees	-	-	1,025,000	169,500
Directors	-	-	325,000	49,000
Consultants	-	-	200,000	20,000
	-	-	1,550,000	238,500

All options were exercised for cash.

THERMAL ENERGY INTERNATIONAL INC.

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

(b) The following options are outstanding and/or exercisable at August 31, 2006:

Number of Options Outstanding	Number of Options Exercisable	Exercise Price Per Share \$	Expiry Date
400,000	400,000	0.15	January 16, 2007
175,714	175,714	0.18	January 16, 2007
193,000	193,000	0.10	January 12, 2008
250,000	250,000	0.20	January 24, 2008
1,000,000	685,000	0.10	February 1, 2008
500,000	342,500	0.12	February 1, 2008
150,000	46,250	0.24	March 1, 2008
950,000	950,000	0.22	April 29, 2008
250,000	250,000	0.24	May 19, 2008
100,000	100,000	0.24	June 2, 2008
150,000	150,000	0.24	June 10, 2008
150,000	150,000	0.24	August 15, 2008
250,000	250,000	0.26	September 9, 2008
4,518,714	3,942,464		

(c) Stock-based compensation to employees

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

	Aug 31, 2006	Aug 31, 2005
Weighted average assumptions:		
Expected dividend	0.00%	0.00%
Expected volatility	111%	122%
Risk-free interest rate	3.85%	3.75%
Expected option life in years	2.4	2.4

There were no options granted in the period ended August 31, 2006. The weighted average fair value of the Company's stock options, calculated using the Black-Scholes option pricing-model, granted during the period ended August 31, 2005 was \$0.18.

(d) Stock-based compensation to non-employees

No options were issued to non-employees in the periods ended August 31, 2006 and 2005.

13 OTHER REVENUE

There was no other revenue in the period ended August 31, 2006. In the period ended August 31, 2005 other revenue of \$221,286 was the result of an agreement to reduce obligations due to the past President.

14 OTHER COSTS

In the quarter ended August 31, 2006, costs of \$14,684 were incurred to remedy a design deficiency of a project.

THERMAL ENERGY INTERNATIONAL INC.

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

15 SEGMENTED INFORMATION

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

Two unaffiliated customers accounted for 100% of sales in the period ended August 31, 2006 and one customer accounted for 100% in 2005. The Company continues to work aggressively with other partners and potential new partners to attract new customers.

16 FINANCIAL INSTRUMENTS

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

Short-term financial instruments

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

Loan receivable

The fair value of loans receivable, all of which have been granted to directors and officers, has not been determined because such transactions have been conducted to maintain favourable business relationships and do not necessarily reflect terms and conditions which would have been negotiated with arm's length parties.

Foreign exchange risk

The Company is exposed to foreign exchange risk due to revenues and accounts payable denominated in U.S. dollars. As at August 31, 2006, accounts receivable and accounts payable denominated in U.S. dollars totalled US\$21,838 and US\$19,663 respectively (US\$nil and US\$67,119 at August 31, 2005).

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

17 COMPARATIVE AMOUNTS

Certain 2005 amounts have been reclassified to conform with the current period's presentation.